THE FLAT RATE TAX

HEARINGS

BEFORE THE

SUBCOMMITTEE ON MONETARY AND FISCAL POLICY

OF THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

NINETY-SEVENTH CONGRESS

SECOND SESSION

JULY 27 AND AUGUST 19, 1982

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

15-073 O WASHINGTON: 1983

J841-13

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THE FLAT RATE TAX

TUESDAY, JULY 27, 1982

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON MONETARY AND FISCAL POLICY
OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:30 a.m., in room 6226, Dirksen Senate Office Building, Hon. Roger W. Jepsen (chairman of the subcommittee) presiding.

Present: Senators Jepsen, Symms, and Quayle; and Representative Reuss.

Also present: James K. Galbraith, executive director; Charles H. Bradford, assistant director; Mark R. Policinski, Charles E. Ludlam, and Richard K. Vedder, professional staff members.

OPENING STATEMENT OF SENATOR JEPSEN, CHAIRMAN

Senator JEPSEN. This morning, the Subcommittee on Monetary and Fiscal Policy begins the first in a series of hearings on the flat rate tax concept. The next hearing is scheduled for August 19 and will include oral testimony and statements for the record from several noted economists, including Milton Friedman.

Our tax system is a mess and the public is rebelling against a tax structure that is increasingly complex and unfair. Millions of otherwise honest Americans are entering the underground economy, leading to a dangerous contempt for our government, the rule of law and to an undermining of the Nation's moral fiber.

The flat rate tax movement is a response to these developments and an attempt to make the Federal income tax simple and fair again and to remove productivity-lowering disincentives incorporated in our tax code.

Today we are fortunate to have four distinguished economists appear before us. Robert Hall and Alvin Rabushka of Stanford University's Hoover Institution have sparked much of the current interest in the flat rate tax with their proposal. Mr. Norman Ture, former Undersecretary of the Treasury, is one of our Nation's leading tax experts. Mr. Joe Minarik, Deputy Assistant Director of the Congressional Budget Office, is also a respected student of our tax system.

I welcome all of you and look forward to hearing your testimony. And we will start as per our prearranged agreement, with Mr. Rabushka.

Welcome.

STATEMENT OF ALVIN RABUSHKA, ECONOMIST, HOOVER INSTITUTION, STANFORD UNIVERSITY, STANFORD, CALIF.

Mr. RABUSHKA. Thank you, Senator. It is a real pleasure to be here, and I take it the size of the audience signifies the rapid growth of interest in this subject.

Let me, right at the beginning, make some preliminary remarks. Bob Hall and I are going to divide up our statement, in which I want to focus on some of the political aspects, some of the historical aspects, some of the virtues and goals of our system. And then Bob Hall is going to look at some of the mechanics and try to make some comparisons with what we propose with some of the other proposals that are currently circulating.

I should mention at the outset that this is not necessarily a brand new subject either in intellectual circles of the United States or, in fact, as it has been applied in other countries around the world. Milton Friedman, among others, proposed an idea very similar to this 20 years ago in his book, "Capitalism and Freedom." And the idea has periodically surfaced.

Also, I should mention for the historical record that there have been a number of countries where, in fact, we have a flat-rate income tax and, in each case, the application of the tax has coincided with remarkable periods of economic growth.

In Britain, for example, between 1842 and 1890, they, in effect, had a low flat-rate system with a personal allowance that was raised from about 2 to 7 percent of the revenue requirements. And perhaps a better example today you would find in Hong Kong, which has, to all intents and purposes, a top marginal flat rate of 15 percent on personal income and 16 percent on corporate income.

And, I might add, they manage these low flat rates with annual budget surpluses, not deficits, not falling revenues, and with a substantial program of public housing, and medical and other benefits; which means there is nothing incompatible between a low, flat, marginal rate and the ability of government to provide services to the needy sectors of society.

There are a number of other small British territories today which also operate with a low, flat tax; so, there's plenty of examples to look at, to see, in fact, how such systems operate. And the bottom line is they seem to go hand in hand with high rates of economic growth and without any difficulties of budget deficits where they've been a part.

Now, as I said the idea has been around for some time. And so we might ask ourselves what is different today which makes it so attractive and so popular compared to 5, or 7, or 8 years ago, where nobody at all would think for a moment to propose such an idea.

The first, I think, is the issue of complexity. The existing code is so complex that one can find up to 500 different forms that individual or firms can use to file their taxes. As a result of this, it is just simply very, very difficult to be sure that you are filling out your taxes correctly, even if you want to fill your taxes out correctly.

I think a second feature is that we have all come to agree that there are adverse economic effects from the system of steeply progressive rates which, under our present system, have the effects of rewarding

borrowing, punishing savings, and having adverse overall impact on the economy's growth rate, resulting in fewer jobs, higher costs.

There is a third area that has come to alarm, I think, more and more of us, and that is the issue of growing noncompliance. The Internal Revenue Service estimates that some $95 billion in unpaid legally owed taxes is not collected, of which only $10 million may be from explicitly criminal activity; that as much as perhaps $300 billion in unreported income is not showing up.

As this continues to happen, we really put at risk the ability of the entire Internal Revenue Code to raise the revenues adequate to conduct legitimate activities of government.

A fourth area may be the rise of tax shelters. There probably isn't a middle-class household in the United States that doesn't have one or more tax shelters, that hasn't studied and looked into tax shelters. It probably is the single most rapidly growing industry in the United States, the selling and consuming of tax shelters.

Last is simply the cost imposed with our present system. I have assembled some numbers from various places. For example, it took, last year, 182 million hours to fill out 87 million tax forms. That doesn't count seeking advice, that only counts the time to fill out your forms. If you place a $10 an hour price tag on that, we're very close to $2 billion alone there.

A good part of the budget of the Internal Revenue Service is simply checking the forms, they are so long and complicated. We now have something like 45,000 tax lawyers in the United States, and the Wall Street Journal reported that 15,000 more would graduate into that business; so, the growth of tax law is the most rapidly rising part of the legal business, not to mention the money spent on accountants and advice from others.

So, I think all of these factors have coalesced today to produce rising interest in simplification as well as bringing high marginal rates down.

When Bob Hall and I first published our initial statement on December 10, in the Wall Street Journal, we were surprised to find two responses. One was that the mail didn't stop coming in in 2 weeks, it kept coming, it kept coming, all the way through April 15 and then increased even after the 15th. This we found to be a sign that we had really touched a raw nerve out there in the American society and we were very gratified to perceive that putting an article like that in the public view would produce such a dramatic response. But second, and much more revealing to us, is that we got more favorable endorsements from people you would expect to oppose a flat tax than from people in favor of it. Accountants and lawyers wrote, saying, "This is fine. We'd be happy to do an honest living somewhere else if we could simplify and refine the system." Human rights and other liberal groups said, "This is fine because we know that the rich could not legally pay no taxes as you can under the present system." There were groups of economists who wrote and thought this was an ideal arrangement to restore and reintroduce some sense into the economy. So, what we have seen here, I think, is the development of a broad base, grassroots, nonpartisan, bipartisan, coalition, which include those members of the political spectrum who are concerned that the rich

don't pay their fair share, those members of the political spectrum who believe that punitive high marginal tax rates have a severe disincentive effect, those people who think that such a proposal might help flush the underground economy upward, in fact help balance the budget, which is something we know today can be very important.

There is also a group of people who think simplification is an exceptionally important point. And so all of these different elements and groups coalesce today to produce a movement which I think does have major grassroots potential.

Let me conclude my opening remarks by talking about what we call the Hall-Rabushka simplified flat-rate tax proposal. And we have the post card up there that I would like to direct your attention to. Because we really do have four principles which underlie our approach to try and bring about major fundamental tax reforms.

We have—and all four of these are extremely important points—four main points which guide the formulation of our proposal. The first point is simplicity. It ought to be the case that every individual can file his tax form on a post card; and, in fact, that is a post card that is simply blown up so that you can read it at a distance.

For businesses we would have one sheet of paper, so that a firm as large as General Motors could file its taxes on a sheet of paper. There would be nothing more in our tax system than one post card for compensation income and one sheet of paper for business income.

A second cardinal principle of our program is to tax all income once and only once, as close as possible to its source. Because under our present system, a good deal of income is not taxed at all. We also are going to tax all income at the same rate; that is, business profits and individual compensation income are going to be taxed at exactly the same rate.

The third point is that we want to have a single, low, flat rate. In our particular proposal we tried to reproduce existing revenues, and, so, we came up with a rate of 19 percent. This is to make clear the proposal as a tax reform proposal. Obviously, if you want to raise more revenue, you could have a higher rate; if you wanted to raise less, you could have a lower rate. But simply to reproduce the existing revenues with our system, a standard flat rate of 19 percent would suffice.

A fourth and equally important principle for us is that poor people should pay no taxes; so, we have a series of personal allowances which more or less also attempts to reproduce the existing allowances and deductions in the present system. And, as a result of that, this is not a plan, in fact, to transfer the tax burden to the lower income groups.

I'll stop at that point, if I may, and let my colleague, Bob Hall, pick it up.

STATEMENT OF ROBERT E. HALL, ECONOMIST, HOOVER INSTITUTION, STANFORD UNIVERSITY, STANFORD, CALIF.

Mr. HALL. Thank you.

The point I would like to stress throughout my remarks is that we have developed a practical and a fully worked out comprehensive tax system. Many economists have testified and will testify about the principles underlying a good tax system, but leave it at that. What we have

done is we have gone much further, and we have even gone to the point of having this tax form prepared. And we stress the point that we have really solved the problems of how you would run a tax system with a flat rate. Comprehensive taxation, equal tax rates, all income taxed exactly once, all of those ideas have been transformed into practical reality in this system that we propose.

Now, in order to highlight what it is that our tax system accomplishes, I think that the point I would like to draw your attention to is that the taxation of higher income taxpayers is really the problem in the current tax system. We concur with the philosophy of today's tax system which does not attempt to impose taxes on the poor. And our system is very similar to the existing tax system as far as treatment of low income taxpayers.

The really crucial problems in the tax system today are in the higher income areas. I don't mean the very rich, but the incomes where the great bulk of American earnings occur. Therefore, I want to give an example of a well-to-do but not super wealthy married couple, and illustrate how much leakage there is in the current tax system in the taxation of such a married couple. So, throughout this I will stress that the problem here is that an awful lot of income is making its way into the hands of this family without passing through the tax system.

Well, here is the profile of the family. It receives a total salary earnings of $50,000. In addition it receives compensation from stock options which have the advantage of the family being taxed as a capital gain. And that is another $20,000. Furthermore, the two wage earners in this family receive fringe benefits which are not taxed at all under our tax system, and they amounted to a total of $10,000.

Furthermore, this is a clever but perfectly honest family, which has found that it is very advantageous for income in the family to accrue to the children rather than to the parents. This is a very common exploitation of the feature of the tax system. and it is a feature which would be eliminated under our proposal. So, instead of holding stocks and bonds themselves, this family puts the stocks and bonds in the names of the children. And the children earn from that source $10,000.

Furthermore, again perfectly legal and perfectly standard, this family has accumulated balances in retirement plans. And the current earnings of those balances constitutes another $10,000. So, the total contribution of this family's national income is $100,000, and the amount that income that is actually taxed, that appears in the personal allowance in form 1040, is $50,000 in salary plus 40 percent of its capital gain, which is $8,000; so, the total is $58,000 in gross income.

But, in addition, this family owns a house, and it has gone into debt for other reasons, and has interest deductions of $20,000. Its taxable income under the current system is only $38,000. The remaining $62,000 of the perfectly genuine income escapes the tax system. That's the leakage in the tax system which is creating all the problems in the taxation of income in the United States today.

Well, what lessons do we learn from this family?

Well, the first and foremost lesson that we learn is that the tax system today requires very high tax rates. In order to get revenue out of families like these—these are the families that contribute the bulk of U.S. tax revenues—we have to impose very high tax rates on these people because we tax so little of their income. They put a great deal of

effort, as we have seen from the various gimmicks that they have used, in order to get as much of their income in the inefficient untaxed form relative to the straightforward tax form; and millions of families are doing that today, so much so that a very large fraction, sometimes 40 percent, of the gross national product disappears before it makes its way into the tax system, through the types of gimmicks that I have just illustrated. And these are all perfectly legal; I'm not talking about the underground economy or even anything that is in the gray area of tax law. This family does not own any tax shelters, and yet $62.000 of its income is leaked out of the tax system.

Well, let me go through some of the particular features of the tax system that are shown as inappropriate in this example.

The first is that tax law which permits compensation and a salary income to be paid out and taxed as a capital gain is inefficient. All it does is it creates incentive for exotic employment arrangements, which are nowhere near as good as far as getting work done than the straightforward one of an hour's pay for an hour's work. So, the first principle that comes out of this is that all salaries and wages should be taxed at the same low rate instead of having some taxed at high rates and others taxed at low rates.

The second point, even stronger, is that fringe benefits that are untaxed altogether in the current tax system create an even greater inefficiency. The firms that hire, that employ, the different members of this family, have incentive to pay a dollar in fringe benefits; even if the family, which is in the 50 percent tax bracket, values those benefits at only 50 cents, because the benefits are untaxed. That is one of the worst features of the current tax system, it creates an incentive to put compensation into the undesirable form which restricts the freedom of the family as to how to spend it. Because fringe benefits cause them to consume too many fringe benefits and not enough of what they would choose freely. So, that problem could be solved easily, and is solved, in our tax proposal by listing the same rate on fringes as our proposal on regular compensation.

Well, the next example, smart parents have rich children. And you should pursue that if you haven't done that already—take my advice—until this tax reform goes in. Enrich your children at your own expense, because it's a bargain. And as long as your children are in low tax brackets, you should transfer income to them. Well, a good tax system would prevent that. Our tax system puts a tax rate on children which, from the first dollar, is exactly the same as the tax rate on the parents. There is no incentive in our system for this inequity and this inefficient gimmick. It is better for the parents to control the income. It's costly to have rich kids, and it's pure artifact of the tax system. And people are pursuing that today.

Interest deductions are something that create an enormous amount of attention in this area, and are the major source of leakage in the tax system second only to fringe benefits as a defect. In theory, there is nothing wrong with interest deductions, of the interest that I deduct is supposed to be someone else's income. That is the whole theory of our tax system. That is why interest deductions were made in the first place. But yet, if I am clever, I will set things up in such a way that although I deduct it at a high marginal rate, the person I am bor-

rowing from manages not to pay income tax on that interest income. That is the problem with interest deductions.

Not everyone in the flat-rate tax movement, I think, has really zeroed in on why it is that interest deductions are such a problem. It is not that the idea is really wrong, it is that the way the tax system works with different tax rates on different taxpayers, and with a very large amount of untaxed income, that is what creates the problems.

In effect, you can go so far as to set up your own untaxed retirement fund and borrow money, yourself, from that fund. The fund pays no income tax on the interest earnings, but you deduct it. And I know people who do exactly that, and it is perfectly legal under the tax system. That is an extreme example, but similar examples go on that take place throughout the economy. That is why interest deductions are such a problem.

Again, we have solved that problem completely by the idea of taxing interest type income at its original source as a business. And individuals—if you study our tax form, you'll see that there is no place where individuals have to report the interest earnings and there is no place where they deduct their interest payments; all interest is done in such a way that the interest that is paid out and received by individuals has already been taxed and it need not be reported or accounted for to the Government at all.

Well, all of these example I've given come from lack of uniformity in tax rates. The problem with the tax system is that different taxpayers pay different tax rates. And we can solve the problems altogether by proposing a principle throughout the economy that all income is taxed exactly once at the same rate. And the only way to achieve that is through a watertight system of the kind that we propose.

I think it is fair to say that if you follow that principle everywhere in the economy, you'll wind up with a tax system very like the one we have proposed. Now, the tax rate that can accomplish that in a watertight system which—does three things. First of all, it balances the Federal budget. Second, it provides strong investment incentives through first-year writeoff of investment under our business tax. And third, and something that is very important, is that it maintains the progressivity of the tax system that we have today. We are not proposing to put a tax burden on the poor beyond the burden that already exists for the upper half of the poor. So, we have a system which minimizes the tax burden of the poor, as an integral part of the design of this tax.

Senator JEPSEN. Excuse me, Mr. Hall, for interrupting.

You know the first one of those three items that you said, the flat-rate tax will balance the Federal budget; is that what you said?

Mr. HALL. That point is elaborated; yes, it is.

Senator JEPSEN. Are you going to elaborate on that?

Mr. HALL. Yes. Let me do that right now. That point is drawn out at length in our joint prepared statement. We don't have time to go through it, but let me just summarize it in two sentences.

If one takes the spending proposals as originally proposed by the President in February in the budget, together with the economic assumptions that underlie that—which, I think, are not unreasonable—and then the 19-percent rate together with the personal allowances

that we have proposed, then the budget comes into balance in fiscal year 1985, and it is very close to balancing in fiscal year 1984, all that is required is a recovery of modest degree from the current recession in order to bring the Federal budget into balance at the 19-percent tax rate.

On the other hand, if you wanted to have a tax of the type that we have proposed which only matched the current revenues—and everyone in Washington is aware that revenue is just not enough to balance the budget—then it would be approximately a 17-percent tax rate rather than a 19-percent tax rate.

We believe that the 19-percent tax rate would be a responsible level to be the permanent level of taxes at the President's proposed level of spending. And so, therefore, I think that our original proposal of 19 percent has turned out to be exactly right. And it is remarkable that one could meet the revenue requirements of the Federal Government and cut taxes in the sense of marginal tax rates dramatically with the same move, to the type of tax system that we propose. It is possible to cut tax rates and raise revenue at the same time through the elimination of the tremendous leakage that exists in the tax system today.

Now, let me discuss a couple of the administrative features of our system. Again, we've thought a great deal, we've listened very carefully to many critics. And we've refined this proposal to the point of being a practical one.

The consistently proposed taxes on wages and salaries that are received by employees in cash, that's the first line on this tax form that we put up there. And that is the only part of the tax system that is visible to everyone in the public. It's the standard for the individual that perceives his income just in the form of compensation plus things like interest and dividends, savings accounts, that type of income, would only fill out this individual compensation tax. That tax replaces the personal income tax today, and is very, very much simpler.

Again, I stress that in addition to being simple, it is progressive. A single large deduction, which is right in the middle of the form, which today for a family of four, in the year 1982, would be $7,700, is what makes our system progressive. You pay no tax at all on $7,700, and you pay 19 percent of income above $7,700. The amount of income going to taxes does not reach even 10 percent until close to $20,000. So, it's a very progressive system.

There is, to go with this and to make this the water-tight tax system that we advocate, a business tax which, again, is exactly the same rate, 19 percent. And that tax is imposed upon every business. This includes very small businesses. For example, a salesman who earns a commission is, therefore, self-employed. He fills out our very simple business tax. It really could fit on a postcard, but we propose putting it on a single sheet of paper; again, a very simple tax.

The way to compute that tax is to take the gross sales, subtract all the wages and salaries paid in cash, purchases of materials, and investment; just a certain set of things which can be deducted. Everything that is left over is the appropriate amount in our tax system to tax. And this business tax, when considered in conjunction with the personal compensation tax, gives a water-tight tax system which taxes each dollar of income in the U.S. economy exactly once.

Senator JEPSEN. Excuse me.

Mr. HALL. Yes.

Senator JEPSEN. For purpose of tracking here, you have the individual compensation tax form, that is this one [indicating to post card].

Mr. HALL. Right.

Senator JEPSEN. Then for those who are not—who do not receive a withholding from their employer on wages, all those others, those are in corporations, businesses? You have a separate——

Mr. HALL. A separate form.

Senator JEPSEN. That separate form is not a post card size but a full page?

Mr. HALL. Well, for people who have our joint prepared statement available, I think it could fit on a post card. But the thing I would stress is that it is very, very simple. The tax principle that is operating here is so much simpler than that that is present in the corporate income tax today.

Representative REUSS. I have the same problem as you, Senator Jepsen.

There has been distributed this Hall-Rabushka simplified flat-rate tax form. But am I right, or do your simplified tax forms, tax just people who work by the sweat of their brows, and those who clip coupons or get dividends or interest don't pay any taxes?

Mr. HALL. No, no, no. Let me be clear on that.

Representative REUSS. Well, I have here an article from Barron's describing your individual compensation tax, in which it says: "Hall and Rabushka would, under their program, all unearned income, that is, dividends and interest, would be tax free."

Mr. HALL. Well, we're speaking here——

Representative REUSS. Is Barron's falsifying your program?

Mr. HALL. They are discussing only one-half of it.

Representative REUSS. Well, I know. But is their one-half right, that you would not tax and put on your post card interest and dividend income?

Mr. HALL. The post card has a title as a "Compensation Tax." The rest of the tax——

Representative REUSS. The one I have is that "Hall-Rabushka simplified flat-rate tax form."

Mr. HALL. The next line: "From 1 individual compensation tax."

Representative REUSS. Yes. But I don't find anything on that Hall-Rabushka simplified flat-rate tax form which taxes so-called unearned income, dividends and interest, pensions, royalties.

Mr. HALL. There are two tax forms in our system. Form 1, which is on a post card, is in front of us here.

Representative REUSS. Could we see form 2?

Mr. HALL. Yes. Form 2 we haven't distributed in the same form.

Representative REUSS. Could we distribute that?

Mr. HALL. If you have a copy of our joint prepared statement you will see how we illustrate the tax form that taxes interest and dividends and other forms of income besides compensation.

Representative REUSS. I see something about a business tax return for corporations.

Mr. HALL. Correct.

Representative REUSS. What about dividends and income for individuals who make their income not by the sweat of their brow but by the clip of their coupons; what about them?

Mr. HALL. Let me explain why we have changed the way we do it. But I want to emphasize throughout that we are taxing that income.

The problem with the current system is that we allow businesses to pay out their income without paying taxes on it, then we rely on individuals to report that. That is the single largest area of unreported income in the U.S. economy. The bulk of recipients of that type of income have figured out hundreds of ways to avoid reporting it, most of them legal. To circumvent that problem we propose comprehensive taxation of interest, dividends, and other income of that type at the source. It is as if, instead of the 10-percent withholding rate that Congress is very reluctantly trying to impose on that type of income today, we are proposing that there be full withholding of all interests and dividend taxes at the source. That is the way. There are only 8,000 large businesses in the United States paying out a very large percentage of all that type of income. Those businesses cannot escape; they have to file taxes, they have to be honest. They are audited very carefully. That is where we are going to catch that income.

We can dramatically raise the tax base and make our whole system possible by taxing that type of income before it is paid to the wealthy, and, therefore, not even give them the beginning of a chance to evade it the way they can today, through our system; which is, essentially, a withholding type of system, but it is a comprehensive water-tight withholding system.

The system that is going in place today with a 10-percent withholding rate is silly because the great bulk of that income is going to taxpayers in the 50-percent tax bracket. So, that's 40 percentage points of taxes that are not——

Representative REUSS. Do you withhold at the rate of 15 percent——

Mr. HALL. No. We withhold at the tax rate of the taxpayers. All taxpayers have the same tax rate, which is 19 percent. Therefore, the withholding system is based on the 19-percent tax rate.

Well, you have illustrated exactly the point I wanted to make next, which is that the key weapon of the Hall-Rabushka system against leakage in the tax system is taxing business income at the source. Of all things in our tax system, it's taxing business income at the source that is the key to capturing the large amount of income which is escaping the tax system today.

At first blush I understand that it appears that we propose that the wealthy should get off without taxation. It is quite the opposite. The practice and the way the system works is that we have figured out a way to make all taxpayers, including the wealthy, pay in a comprehensive way exactly the taxes due on all of their interest, dividends, and other business type income, and together, the compensation tax plus the business tax, executive tax, all income that is generated in the United States. And no other tax system has come close to achieving that level of taxation.

Let me close with just a few remarks about comparison with other so-called flat tax plans, of which the Bradley-Gephart proposal is the one that is now most conspicuous, and it has been the most well worked out.

Well, in the first place, the whole issue of taxation of business income and the elimination of the leakage of the tax system that exists today has escaped attention from any other flat tax avenues, including

the Bradley-Gephart proposal. You must have a business tax as a part of a flat tax in order to get the incentive for capital formation, low marginal rates, all of the other features that I have emphasized today.

The business side of this tax proposal really is the key to it. And it is the integration of business tax and a compensation tax that makes this whole thing work. Nobody else has really thought through what it means to put a flat tax on all income other than just a flat tax on the income that makes its way to the tax returns filed by individual taxpayers; 40 percent of the national income does not make its way there and must be taxed under an inefficient tax. That is the problem we have solved and no one else in the flat-tax movement has really thought that through and provided the answer to the problem of taxing business income.

The other feature, which is equally important, is that all of the advantages that I have pointed to in eliminating leakage rely on all taxpayers having the same tax rate. Now, the Bradley-Gephart proposal isn't a flat tax; it has a surcharge tax rate for higher income taxpayers which puts us back into exactly the type of game that can be played today. For example, under Bradley-Gephart the same incentive that exists today for transferring income to children exists, because they can file, down at the bottom of the schedule, for the lowest marginal rate and escape the taxes that their parents would have to pay at the higher rate. The flat rate of 19 percent, which we advocate imposed on all taxpayers, would eliminate that incentive.

So, all the problems of leakage—leakage is the phenomenon in any tax system where different taxpayers pay different tax rates—those problems could be eliminated by going from a Bradley-Gephart-type proposal in two essential directions: One is putting the same, flat-tax rate, same marginal rate, on all taxpayers, getting rid of the idea of rising marginal rates, which is what creates leakage; and the other is extending the tax to cover the business sector, that is absolutely essential in order to capture the tremendous amount of business incomes which is escaping untaxed today.

So, finally, let me summarize with the four criteria which we have set forth for a tax system which we feel we've achieved:

Simplicity. That is very evident just from looking at the design of the forms.

Taxation of income at the source. We have amplified on that at length. But that is, really, absolutely essential; that is what makes our flat-tax proposal neat.

Low and equal marginal rates. You cannot have a tax system that deals effectively with leakage except by having all taxpayers pay the same marginal rate.

And, finally, progressivity. That is, to my mind, essential that a tax system minimize tax burdens on the poor and aim flat taxes for the heart where most U.S. income is earned; and that is the upper-middle-class type of taxpayers that I illustrated at the beginning.

Our tax system achieves all four of those; the tax system that we have today achieves none of them. Other flat-tax proposals go part way; the proposal that we made accomplishes all four results.

Thank you.

[The joint prepared statement of Mr. Rabushka and Mr. Hall follows:]

JOINT PREPARED STATEMENT OF ALVIN RABUSHKA AND ROBERT E. HALL

A Simple Income Tax with Low Marginal Rates

Robert E. Hall

Alvin Rabushka

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HALL-RABUSHKA SIMPLIFIED FLAT-RATE TAX FORM

Form 1	Individual Compensation Tax	1982
Your first name and initial of joint return, last name if spouse's name and initial	Last name	Your social security number
Present home address (Number and street, including apartment number, or rural route)		Spouse's social security no.
City, town or post office, State and ZIP code	Your occupation ►	
	Spouse's occupation ►	

1	Compensation as reported by employer	1	
2	Other wage income, including pensions paid directly by employer	2	
3	Total compensation *(line 1 plus line 2)*	3	
4	Personal allowance		
	(a) ☐ $6200 for married filing jointly	4(a)	
	(b) ☐ $3800 for single	4(b)	
	(c) ☐ $5600 for single head of household	4(c)	
5	Number of dependents, not including spouse	5	
6	Personal allowances for dependents *(line 5 multiplied by $750)*	6	
7	Total personal allowances *(line 4 plus line 6)*	7	
8	Taxable compensation *(line 3 less line 7)*	8	
9	Tax *(19% of line 8)*	9	
10	Tax withheld by employer	10	
11	Tax due *(line 9 less line 10, if positive)*	11	
12	Refund due *(line 10 less line 9, if positive)*	12	

January 1982

Revised July 1982

Despite recent progress in lowering rates, the American tax system remains a disgrace, in dire need of simplification and reform. It is inordinately lengthy, filling volumes of tax codes, complicated by hundreds of credits, exemptions, and special provisions. Many taxpayers require expensive professional help to fill out their tax returns correctly. Each act of the Congress further complicates the system. Political promises of real simplification and reform of the tax system remain unfulfilled.

The tax system consists chiefly of the personal income tax, the corporate income tax, and the payroll tax for social security. The personal income tax has steeply progressive rates, rising to a maximum marginal rate of 50 percent under the new tax law. The income base to which these progressive rates are applied has steadily eroded over the years through a wide variety of exclusions, deductions, and exemptions to the point where it now constitutes no more than half of total national income. The personal income tax discourages savings. Income is first taxed when earned and again when savings earn interest. Even worse, the returns to savings put into the corporate sector are taxed twice, once as corporate profits, and again at the household level when dividends are paid. A growing chorus of criticism contends that the current system attenuates individual incentives to work,

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save and invest. For many taxpayers, saving a dollar in taxes is worth twice as much as earning another dollar in income.

Prior to the twentieth century, federal revenues, comprising about 3 percent of GNP, were largely collected from customs duties. With the adoption of the Sixteenth Amendment in 1913 and the payroll tax in the 1930s, federal revenues have grown to consume 22 percent of GNP. Escalating inflation in the 1970s pushed growing numbers of taxpayers into high tax brackets that twenty years ago were meant only for the very rich. Costly side effects have begun to surface.

Scholarly research, along with Internal Revenue Service reports, reveals widespread evidence of tax evasion on interest, dividend, and other forms of household or professional income. Tax shelters are now a commonplace feature of the financial landscape. Estimates of the underground economy range from several tens of billions to several hundred billion dollars. In the eighteenth century, customs duties exceeding 100 percent made England into a nation of smugglers. Today, marginal tax rates of 50 percent from the personal income tax, 46 percent from the corporate tax, and 14 percent from the payroll tax are converting Americans into tax avoiders and channeling their investments into tax shelters. The current system fosters contempt for the law, simultaneously discouraging productive economic activity.

Why is it so difficult to reform the tax system? Most scholars, lawmakers and practitioners routinely claim that it is politically infeasible to simplify and reform radically the tax system. Talk of simplification is a sign of unrealism. Congress would, it is alleged, never abolish the exemptions and deductions for mortgage interest payments, charitable contributions, excess medical care costs, or remove the many benefits and credits enjoyed by low-income households and a bevy of special interest groups. The American demand for justice means that the rich should pay higher taxes. As a result of these beliefs, changes in the tax code are invariably incremental and represent slight modifications to the corporate or personal income tax.

We sense growing interest in the public and in Congress for drastic reform in the tax system. As a contribution to the debate and discussion on this important subject, we propose a simple income tax based on low marginal rates to replace the entire current system of separate tax rate schedules on corporate and individual income. The new tax would be a low, flat rate applied to all taxpayers, excluding the very poor, and to all types of income. It would be applied to a much larger tax base than the present system, thus generating similar amounts of revenue as the current high-rate system with its exemptions and deductions. The simple flat rate would end "bracket creep," which is caused by inflation pushing people into

higher and higher tax brackets. It would largely minimize the penalty current law imposes on two-earner households ("the marriage penalty"). It would be stable, predictable, and cease further proliferation of a variety of tax credits used to attain social goals. Most important, it would restore the incentives to work, save and invest, thereby promoting growth and higher standards of living.

Our proposal does not include reform of the social security payroll tax and the retirement benefits it finances, though reform is long overdue. The social security tax cannot be discussed separately from benefits, and we would be taken too far from our basic subject of tax reform to go into the massive changes in social security needed to put the system on a sound footing.

Basic Principles of the Simple Income Tax

The simple income tax rests on four basic principles:

1. All income should be taxed only once, as close as possible to its source.
2. All types of income should be taxed at the same rate.
3. The poorest households should pay no income tax.
4. Tax returns for both households and businesses should be simple enough to fit on a postcard or one page.

We propose the replacement of the existing corporate and personal income taxes with a business tax and a compensation tax. The business tax includes the earnings of corporations, unincorporated businesses, farms, professionals, and rental income. The business tax does not permit a deduction for interest payments, dividends, or other payments to the owners of the business. As a result, all income that individuals receive from business activity has already been taxed, and should not be taxed again. The same holds for capital gains. The business tax is like a withholding tax; it means that the tax authorities do not have to track down all the interest, dividends, capital

gains, and other business income received by the public. Compensation is the only element of household income not taxed under the business tax. We therefore propose a new compensation tax to replace the present personal income tax. The new compensation tax would have a set of personal allowances to insure that the poorest families pay no compensation tax.

Under our existing laws, tax rates can be as high as 50 percent for compensation and 80 percent for business income, because income is taxed first under the corporate tax and again under the personal tax. To collect the same amount of revenue that the present system generates, assuming the same flows of income as occur today, the simple tax system would require a standard rate of only 19 percent.

The Business Tax

The new business tax would rationalize the present hodge-podge of federal tax provisions for business income. It would reduce the high marginal rates currently paid on some types of income from capital. By eliminating interest deductions, it would also end the subsidies embodied in current tax shelters. A uniform rate of 19 percent would replace the current range of tax rates that stretch from actual subsidy of highly leveraged tax shelters with large interest deductions to rates as high as 80 percent imposed

on income earned by corporate stockholders.

The new business tax applies equally to all forms of business--corporate, partnership, professional, farm, and rentals and royalties. The base for the tax is gross revenue less purchases of goods and services and compensation paid to employees. In addition, a capital recovery allowance is deducted for investment in plant and equipment. No deductions for depreciation, interest, or payments to owners are permitted. However, the self-employed may pay themselves salary in any amount they choose, provided they report it on the compensation tax form.

The business tax return would fit easily on a single page, even for a multibillion dollar corporation. Here is what it would look like:

1	Gross revenue from sales
	Costs
2	Purchases of goods and materials
3	Wages, salaries, and pensions paid to employees
4	Other costs
5	Total costs (lines 2, 3, and 4)
6	Net revenue (line 1 less line 5)
7	Purchases of capital equipment and structures
8	Taxable income (line 6 less line 7)
9	Tax (19 percent of line 8)

10 Tax carry-forward from losses in previous years

11 Net tax (line 9 less line 10)

12 Tax payment (amount on line 11 if positive)

13 Carry-forward to next year (amount on line 11 if negative)

Gross revenue from sales does not include earnings the business may receive from its ownership of other businesses (provided these businesses file their own tax returns) or from its ownership of securities. These earnings have already been taxed in other businesses. Gross revenue does include sales of used plant and equipment. Businesses are not required to maintain inventory or depreciation accounts for tax purposes.

In place of the hodge-podge of investment incentives in the current tax system, we propose the use of straightforward first-year writeoff of all business investment, both in new and used plant and equipment. First-year capital recovery is a great simplification over the complicated depreciation deductions and investment credits in present tax law. It also eliminates the present problem that depreciation based on historical cost is not rapid enough to offset the effects of inflation. The first-year system avoids all distortions of inflation.

In 1981, the net revenue of U.S. business was $1050 billion. Under the new business tax, capital recovery allowances would have been $349 billion, leaving net

taxable business income at $701 billion. A tax rate of 19 percent would have yielded $133 billion, well over double the revenue from the actual corporate income tax in 1981 of $57 billion. The extra revenue, despite the much lower tax rate, comes from (1) the much wider tax base, including unincorporated business, and (2) taxing business income at its source.

Under the simple tax system, all business income would be taxed only once, at its source. Household receipts of interest, dividends, and capital gains would be after-tax income. Though wealthy households might receive large amounts of these types of income, it is important to understand that the taxes on this income have already been paid. The recipient household itself should not pay any more tax on business income. Taxing business income at its source has an important practical benefit. Under the present personal income tax, large amounts of interest and dividend income escape taxation through outright evasion and tax avoidance. Apparently people find it easy to overlook these types of income when filling out personal income tax returns. Under our business tax, the only way dividends, interest, and other earnings of capital could escape taxation would be for the business to fail to file a tax return, which is easier to detect and punish.

Capital gains on rental property, plant, and equipment are taxed under the business tax. The purchase price is deducted at the time of purchase, and the sale price is

taxed at the time of the sale. These provisions are most important for real estate, where they will eliminate the current abuses in which low capital gains tax rates create an incentive for artificial turnover of property. Every owner of rental real estate would be required to fill out the simple business tax return.

Capital gains in the overall value of a successful firm are also taxed under the new business tax and should not be taxed again at the household level. To see this point, consider the case of the common stock of a corporation. The value of its stock in the market is the capitalization of its future earnings. Because the owners of the stock receive the earnings after the corporation has paid the business tax, that tax depresses the stock's market value. When the market learns that future earnings are likely to be higher than previously thought, the stock rises in value and its owners receive capital gains. When the high earnings materialize in the future, they will be correspondingly taxed. To tax the immediate capital gains of the stock would be double taxation. Thus with comprehensive taxation of business income at the source, capital gains should be excluded from taxation at the household level.

In order to impose the appropriate tax on banks and certain other types of business, it is necessary to separate the value of the service the bank provides to its customers from the interest the bank pays to the customer.

Today, most banks net one against the other, so the customer gets free services in exchange for lending the bank funds at zero or below-market interest rates. Because the business tax is imposed on the value of the product sold by a business (the services provided by a bank, for example), but does not allow a deduction for interest paid out, it would not be permissable for a bank to report the net receipts from its customers as its sales. Instead, it must add in the difference between the interest its pays its depositors and the full market interest rate they could earn elsewhere. As a general matter, businesses would not be permitted to borrow from their customers and pretend that the value of sales was only the net charge after deducting interest--this violates the basic principle that interest payments are never deductible. Businesses like banks could continue to carry on their relations with their customers in any way they chose, but for tax purposes, the full value of their services would be reported as their sales.

One other potential source of abuse of the business tax would need to be monitored--the conversion of business assets to personal use. There is nothing new about this problem--under today's income tax, one can buy a car for business purposes at the end of the year, take the investment credit, and then convert the car to personal use at the beginning of the next year. Under the proposed business tax, conversion to personal use would be counted

as a sale, and the market value of the asset would be included in the revenue of the firm. Auditors would check that the assets on the books of the firm were actually used by the firm and not for the personal use of the owners.

First-year writeoff of investment would create large tax losses in the startup years for almost all businesses and occasional large tax losses even for established businesses when they made significant investments. The business tax provides unilimited carry-forward of tax losses so that they reduce taxes in future, profitable years. Further, the balances carried forward earn interest at the market rate.

The Compensation Tax

Most income in the United States is compensation for work. We propose that compensation be taxed at the level of the individual or married couple. Compensation is defined as cash wages, salaries and pensions received by workers from employers. Pension contributions and other fringe benefits paid by employers are not counted as part of compensation.

To limit the tax burden of poor families, we propose a set of personal allowances. Taxes would be 19 percent of compensation in excess of personal allowances. The proposed allowances for 1982 are

Married Couple	$6200
Single	3800
Single head of household	5600
Each dependent	750

Except for the personal allowances, no deductions of any kind would be permitted, including interest deductions.

The tax return for the compensation tax would fit on a postcard. It would look like this:

1 Wages and salary

2 Other wage income, including pensions

3 Total compensation (line 1 plus line 2)

4 Personal allowance

$6200 for married filing jointly

3800 for single

5600 for single head of household

5 Number of dependents, not including spouse

6 Personal allowances for dependents

(line 5 multiplied by $750)

7 Total personal allowances (line 4 plus line 6)

8 Taxable compensation (line 3 less line 7)

9 Tax (19 percent of line 8)

10 Tax withheld by employer

11 Tax due (line 9 less line 10, if positive)

12 Refund due (line 10 less line 9, if positive)

In 1981, wages, salaries, and private pensions were about $1603 billion. We estimate that personal allowances in 1981 would have been $481 billion, leaving taxable compensation of $1122 billion. At a rate of 19 percent, tax revenues would have been $213 billion. By comparison, the personal income tax in 1981 yielded about $289 billion. The required revenue from the compensation tax is less than from the personal income tax it replaces because the business tax covers part of the tax base of the current personal tax. The reasons that a low rate of 19 percent yields revenue reasonably close to that obtained from the current tax system are: (1) the business tax includes

currently untaxed fringes in its base, (2) the current income tax fails to tax fully dividends, interest, and other forms of business income because of widespread evasion and avoidance, and (3) the current tax allows a number of deductions not included in our proposal, the most important of which is the deduction of state and local taxes.

International Aspects of the Simple Tax

The simple tax meshes neatly with the tax systems of the major U.S. trading partners under the following simple principle: Purchases from outside the U.S. are not deductible as costs under the business tax, and export sales are not counted as revenue. If every nation used the simple tax and followed this principle, all income throughout the world would be taxed once and only once. Because the principle is already in use in the many nations with value added taxes, it makes sense for the U.S. to adopt it as well.

The principle amounts to saying that each nation taxes the income generated from activities within its borders. For example, if a U.S. business purchases inputs and hires labor in a foreign country and sells the resulting product in that country, it receives neither deductions nor revenue for U.S. tax purposes. A foreign business operating within the U.S., using U.S. labor and selling its output here, is taxed exactly as if it were a U.S. business.

By the same principle, the compensation tax applies to the earnings of everyone working within the U.S., whether or not they are Americans, but does not apply to the foreign earnings of Americans.

Under this principle, choices about where to locate businesses and where to work would be influenced by

differences in tax rates. The U.S., with the low marginal rate of 19 percent, would be much the most attractive location among major industrial nations from the point of view of taxation. Although the simple tax does not tax the overseas earnings of Americans, there is no reason to fear a mass exodus of businesses and workers. Taxation of those earnings in the countries where they originated is more burdensome than in the U.S. under the simple tax.

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Balancing the Budget with a Simple Tax

If federal spending can be held to the level proposed by the President in his budget for the 1983 fiscal year, or if any increases can be financed by user fees or earmarked taxes, then the 19 percent tax rate would balance the budget by 1985.

Even if spending is at the high level projected in the Congressional Budget Office's baseline budget, a tax rate of 19 percent would bring the federal deficit down to $75 billion by 1987.

Under the President's spending proposals, the tax rates necessary to balance the budget starting in FY 83 would be 21 percent in that year, 20 percent in 1984, and 19 percent in 1985.

Under the higher CBO baseline spending projections, the tax rates necessary to balance the budget would be 23 percent in 1983 and 1984, 22 percent in 1985, 21 percent in 1986, and 20 percent in 1987.

Immediate adoption of the simple tax would bring moderate deficits during the current recession, but would commit the nation to a balanced budget within three years, provided spending is kept at reasonable levels.

The base for the simple tax is gross national product less indirect business taxes and investment. In arriving at the conclusions just stated, we used projections of GNP

from the President's budget and from the CBO. We approximated the base as 79 percent of GNP, based on detailed calculations for 1980.

The simple tax allows each taxpaying individual or family to deduct a personal allowance. These allowances are indexed according to the cost of living from the proposals for 1981. The total allowance for a husband, wife, and two children in 1983 would be $8355.

Our estimates of total allowances were derived from our estimate for 1981 by assuming one percent annual growth in the number of taxpayers and rates of increase of the cost of living from the President's budget and from the CBO baseline projections.

The simple tax replaces the personal and corporate taxes, but not the rest of the federal tax system (of which the social security payroll tax is by far the most important part). Our computations take a projection of total federal spending less a projection of revenue from the other taxes. If the simple tax yields exactly this amount of revenue, it would just balance the budget.

The computations take account of the influence of past deficits on current spending through the interest on the national debt. We used the projections of the Treasury bill interest rate underlying the President's budget and the CBO projections in order to track the effect of a reduced national debt on interest expense.

We do not attempt to take account of the influence of tax

reform on total economic activity and the corresponding augmentation of federal revenue, though we think these effects could be substantial.

Details of the future budgetary implications of the simple tax appear in Appendix 2.

The Future of the Economy under the Simple Income Tax

At the outset, the simple income tax, with common flat rates of 19 percent on business income and compensation, would raise revenue equal to about 12 percent of GNP, the same as the current combination of corporate and personal income taxes. The personal allowances under our proposed tax system are raised from year to year in line with inflation, which would tend to hold its revenue constant as a fraction of GNP (the new law provides for this kind of indexation starting in 1985).

The switch from the current corporate and personal income taxes to the simple income tax would have some mild transitional effects on the U.S. economy. Briefly, the elimination of depreciation deductions for business would be costly to the owners of existing plant and equipment, but this would be largely offset by the reduction in the taxation of the earnings of capital assets. We do not think any special compensation is necessary for the loss.

Adoption of the simple tax would lower interest rates. Rates would fall immediately because investors would require a lower rate of interest when they were no longer paying tax on the interest. In the medium run, the investment boom set off by the more favorable tax treatment of capital formation might bring interest rates partway back to their earlier level. In the long run, interest

rates would decline as capital accumulation proceeded. Prices of bonds would rise as soon as the tax was announced. None of these effects would be large, and none seems to call for any corrective action by the government. Compared to the gigantic capital losses inflicted on bondholders by inflation and rising taxes over the past decade, and the corresponding capital gains accruing to homeowners over the same period, neither of which has been offset by any government policy, the effects of the simple tax in the opposite direction are mild.

Though our system will stabilize revenue as a fraction of GNP, it will probably produce more revenue than the government needs to maintain existing programs. Low marginal tax rates will draw economic activities from the underground economy into the formal market, where they are recorded as part of GNP. Businesses and individuals will spend less time worrying about the tax consequences of their actions and will concentrate instead on earning higher incomes. On these grounds, we believe that the revenue needs of the federal government could be met with tax rates as low as 16 or 17 percent, rather than the 19 percent needed to reproduce current revenue at current levels of GNP.

Over the postwar period, cuts in marginal tax rates have coincided with episodes of vigorous economic growth and reduced inflation in the United States. Moreover, those nations with lower marginal tax rates have achieved the

highest economic growth over the past decade. The growth stimulated by tax reform is not only favorable for the increased income it would bring to the American public, but it would also moderate and eventually eliminate the federal budget deficit.

The benefits of tax reform are not purely economic. The complexities of the federal tax system foster contempt for government and make petty criminals out of a large fraction of the population. A simplified tax with low marginal rates would help restore confidence in government and would support the basic honesty of the American people.

Appendix 1. Income flows and tax yields

Following are the relevant numbers from the U.S. National Income and Product Accounts for 1981. All data are in billions of current dollars.

Gross national product[1]	2922
Indirect business tax[2]	251
Imputed rent[3]	18
Wages, salaries, and pensions[4]	1603
Investment[5]	349
Taxable business income[6]	701
Revenue from the business tax at 19%	133
Taxable compensation[7]	1122
Revenue from compensation tax at 19%	213
Total tax revenue	346
Actual personal income tax[8]	289
Actual corporate income tax[9]	57
Total actual tax revenue	348

Notes:

[1] Economic Report of the President, January 1982, Table B-1

[2] ERP, Table B-19

[3] our estimate

[4] ERP, Table B-21 plus our estimate of private pensions

[5] Business investment is estimated as total investment in equipment, nonresidential structures, and farm investment, plus 20 percent of investment in residential structures, ERP, Table B-15. The remaining 80 percent of residential structures are owner-occupied and not deductible under the business tax.

[6] Gross national product less indirect business taxes, wages, salaries and pensions, imputed rent, and investment

[7]Wages, salaries, and pensions less personal allowances

[8]Estimated as 75 percent of the revenue for fiscal year 1981 and 25 percent of the revenue for fiscal year 1982, ERP, Table B-19

[9]Same as personal income tax

Appendix 2. Revenue and deficit projections

Table 1 presents our computations based on the economic assumptions and spending proposals in the President's February budget.

Table 1

	81	82	83	84	85
GNP	2922	3159	3522	3881	4257
Tax base	2314	2502	2789	3074	3372
Allowances	481	535	580	620	655
Tax. inc.	1833	1967	2210	2454	2717
Tx.inc.,FY	1790	1933	2149	2393	2651
Rev. P&C tax	347	345	370	407	450
Rate, sm rv	19.4	17.8	17.2	17.0	17.0
Rate, 0 def			21.2	20.0	19.0
Rev. at 19%			408	455	504
Def. at 19%	58	99	51	29	8

The first four lines compute the level of taxable income on a calendar year basis. The fifth line gives taxable income on a fiscal year basis. When divided into an estimate of required revenue, taxable income gives the necessary tax rate under the simple tax.

The next line, labeled "Rev. P&C tax", gives the administration's estimates of the revenue from the personal and corporate income taxes, including the effects of ERTA and the

modifications proposed by the President in February. The line below, labeled "Rate, sm rv," gives the rate under the simple tax necessary to yield the same revenue as the personal and corporate income taxes. Note that the rate declines from around 19 percent in 1981 to 17 percent in later years, as the major personal tax reductions of 1982 and 1983 go into effect.

The next line, labeled "Rate, 0 def," gives the simple tax rate necessary to eliminate the deficit starting in FY 1983. Though this rate starts above 21 percent, it falls to 19 percent by 1985. Again, these computations take account of the favorable effect on interest costs of lower deficits in earlier years.

The last line shows the projected size of the federal deficit if the simple tax were adopted starting in FY 83 at a constant rate of 19 percent. The deficit is manageable in all years and essentially disappears in 1985.

Table 2 presents similar computations for the CBO's baseline budget projections.

Table 2

	81	82	83	84	85	86	87
GNP	2922	3140	3515	3882	4259	4659	5083
Tax base	2314	2487	2784	3075	3373	3690	4026
Allowances	481	535	581	627	676	726	777
Tax. inc.	1833	1952	2203	2448	2697	2964	3249

Tx.inc.,FY	1790	1922	2140	2387	2635	2897	3178
Rev. P&C tax	347	350	354	378	407	431	469
Rate, sm rv	19.4	18.2	16.5	15.8	15.4	14.9	14.8
Rate, 0 def			23.4	22.5	21.7	20.9	20.2
Def. at 19%			101	102	97	87	75

The format of this table is the same as that of Table 1, except that it covers two additional years. The Administration and the CBO are projecting GNP at about the same level through 1985, though the Adminstration foresees higher levels of real growth and lower rates of inflation. Allowances grow more rapidly under the CBO projection as a consequence.

The simple tax rates necessary to raise the same revenue as the personal and corporate income taxes fall to even lower levels--below 15 percent--under the CBO's assumptions, because the Administration's revenue enhancements are not included in the baseline. On the other hand, the tax rate necessary to balance the budget starting in FY 83, shown in the next-to-last line in the table, is about a point higher because the CBO projects significantly higher federal spending than does the Administration.

The last line of Table 2 shows that with higher spending and weaker real growth, the simple tax at a fixed rate of 19 percent does not eliminate the federal deficit even by 1987. However, it does bring it well below $100 billion, as against the CBO's projection of nearly $250 billion.

Sources

Budget of the United States Government, Fiscal Year 1983, February 1982

Congressional Budget Office, Baseline Budget Projections for Fiscal Years 1983-1987, A Report to the Senate and House Committees on the Budget--Part II, February 1982

Questions and Answers About the Simple Tax

Deductions

Q: What about charitable deductions?

A: No charitable deductions would be allowed under the simple income tax. We do not believe that current tax incentives are a major part of the motivation to make contributions to community, religious, and other organizations who qualify for deductions at present. A large volume of contributions are made by people who cannot deduct the contributions because they do not itemize deductions. Deductibility of contributions is widely abused by wealthy taxpayers to avoid taxes. On net, the public is better off by paying a little more in personal contributions and saving taxes by blocking these abuses. There is little merit in public subsidy for organizations whose success in raising funds depends on tax deductibility rather than the intrinsic merit of their activities.

Q: What would happen to the restaurant industry?

A: Though business meals are an important element of the restaurant industry, there is no reason to expect that the simple tax would reduce restaurant patronage. Neither the existing tax system nor the simple tax gives business an

incentive to spend money at restaurants rather than anywhere else. All reasonable business expenses, including restaurant meals, are deductible under either tax system. A limited amount of restaurant spending may arise from abuse of the current system by providing untaxed income to employees. This problem would be alleviated under a tax system with lower marginal rates. On the other hand, as the new tax system brings businesses out of the underground economy and into the market, taxed economy, spending at restaurants will be slightly increased. Neither effect should be large. The restaurant industry also stands to gain from the incentive effects of lower taxation of many of its employees.

Q: Shouldn't the tax system provide some relief to families with high medical costs?

A: Virtually the entire U.S. population is now covered by medical insurance, Medicare, or medical benefits through welfare. The medical deduction under the current personal income tax is a source of many abuses, including the deduction of swimming pools and other home improvements as medical expenses. Few families would suffer, and the overwhelming majority would gain, by closing off this source of abuse.

Q: Why is there no deduction for moving costs in the simple tax?

A: Moving costs are only one of hundreds of costs incurred by taxpayers in order to earn an income. It is inconsistent to permit deduction of moving costs when costs of commuting, purchase of special clothing, and other employment costs cannot be deducted. Many moves are undertaken for reasons unrelated to earning a higher income and so should not escape taxation. The deduction for moving expenses is one of a number of tax provisions abused by a small minority of taxpayers at the expense of the great majority. It should be eliminated.

Q: I am a salaried employee. How would I treat unreimbursed business expenses? There is no room for this deduction on the simple individual compensation tax form.

A: Deduction of so-called business expenses of salaried employees is a major loophole in the current tax system. It is widely abused to subsidize summer travel for teachers, trips to conventions, and other activities for which special incentives are inappropriate. Genuine business expenses ought to be borne by employers, in which case they are deductible under the business tax.

Housing

Q: What would happen to the housing market as a result of ending the deduction for mortage interest?

A: The simple tax would end the deduction for interest of

all kinds, not just mortgage interest. It would not discriminate against housing. However, improvements in the taxation of business investment would tend to draw wealth out of housing and into plant and equipment, which might reduce housing values temporarily. The effect would not be more than a few percent, and would last only for the duration of the investment boom set off by the new tax system. In the longer run, the outlook for housing values would be improved as overall economic activity increased in response to the tax.

Q: How would the flat tax affect the savings and loans, who are in so much trouble today?

A: Like all owners of long-term debt, savings and loans would receive a benefit from the lower interest rates brought by the flat tax. The market value of their mortgages would rise as interest rates fell, improving their currently depressed net worth. Because the interest the savings and loans would pay on their borrowing would fall, their operating deficits would decline.

Q: Why shouldn't we tax the capital gain from the sale of a house?

A: These capital gains are rarely taxed under the current system, because of the rollover provision, forgiveness of capital gains for the elderly, and the stepping up of the basis for capital gains at the time of inheritance. We

believe that the taxation of housing is properly ceded to local governments under the federal system. Local property taxes capture part of the value of the services of a house. A capital gain occurs when the market valuation of the services rises. These gains arise from after-tax income, just as capital gains from the ownership of business arise from after-tax income. Hence taxation of capital gains would amount to double taxation.

Q: The only way I can afford my house today is the large tax deduction I get for the interest on my mortgage. Won't I have to sell my house if I can no longer take the deduction?

A: Don't overlook the benefits you will receive from a much lower tax rate. Suppose you and your husband earn $60,000 per year and pay $18,000 in mortgage interest. Your tax in 1981 would be $11,553, after taking account of the large deduction for interest. Under the simple tax, you would not be able to take the deduction--your tax would be 19 percent of $55,000, or $10,450. You come out more than a thousand dollars ahead, even though you can no longer take the deduction. If you could afford your house before, you can certainly afford it now. However, if you have been extremely aggressive in taking advantage of interest deductions, so you are paying little tax in spite of a large income, you will come out behind with the simple tax.

Intergovernmental relations

Q: How would local governments be affected by the change in the taxation of bonds?

A: Local governments derive a small advantage from the tax-free status of their bonds and the taxation of all competing bonds in the current system. Under the simple tax, local government bonds would remain untaxed, but all other bonds would also provide tax-free interest, because the earnings of business would be taxed at the source. The immediate impact of the simple tax would lower the borrowing costs of other borrowers to the levels paid by local governments. In the ensuing investment boom, as interest rates rose, local borrowing costs would gradually rise. The slightly adverse effect on local governments would be confined to a few years, and would not be large. In the longer run, local governments would face no higher interest rates and would benefit in many other ways from the improved performance of the U.S. economy.

Q: What about such other taxes as state, county, excise, and sales taxes? What would happen to them under the simple income tax?

A: Although we would prefer that other government units besides the federal government switch to taxes based on the same principle as the simple income tax, we have limited

our proposal to federal action. The only important implication of our proposal for other taxes is the elimination of the deduction for other taxes under the federal personal income tax. Because this deduction is important only for higher-income families, who benefit enormously from lower marginal tax rates, we do not believe that the elimination of deduction will have any harmful effects.

Q: How would the simple income tax affect state taxes where the tax returns are linked to the federal tax system?
A: Because the new federal taxes would raise approximately the same revenue as the old taxes, a state that retained the linkage would continue to receive about the same revenue as well.

Q: How does the simple tax treat government? Are state and local activities taxed? Does the federal government tax itself?
A: State and local governments pay no taxes themselves, but their employees pay the compensation tax on their wages, salaries, and pensions. Similarly, the federal government does not tax itself, but its employees pay the compensation tax.

Retirement

Q: How are existing IRA and Keough retirement accounts treated under the simple tax?

A: IRA and Keough accounts have provided benefits to a limited fraction of taxpayers of the same type that the simple tax would provide to all taxpayers. Under the simple tax, they would be treated exactly as under the current system, except that the tax rate would usually be much lower. When the accounts begin to pay retirement benefits, those benefits would be taxed as compensation. It would no longer be necessary to impose a minimum age for the payment of benefits. Holders of IRA and Keough accounts could elect to liquidate their accounts at any time, and pay the compensation tax at that time. For the future, IRA and Keough accounts would not be necessary, because the taxation of interest income at the business rather than the personal level would make any form of savings have the same advantage as IRAs and Keoughs have today.

Business and the rich

Q: Isn't the simple tax a windfall to the rich?

A: Taxation of families with high incomes and few deductions would be dramatically reduced under the simple tax. On the other hand, taxes paid by those who take advantage of the almost unlimited scope for reducing or postponing taxes through tax shelters and other gimmicks

will rise a great deal. The simple tax would be a windfall to the hard workers and a loss to those who have concentrated on avoiding tax.

Q: Is the simple tax progressive?

A: The simple tax is progressive in the sense that families with higher incomes pay a larger fraction of their incomes in taxes. Families with incomes below the personal allowance level pay no tax at all. The proportion of income paid in tax rises to close to 19 percent for the highest income. Proportions of income paid as tax are

Income	Tax
10,000	4.4 %
15,000	9.2
20,000	11.7
30,000	14.1
40,000	15.2
50,000	16.1

Compared to the current tax schedule, the simple tax is less progressive. Compared to the actual operation of the current tax system, the simple tax may be more progressive.

Q: Does business pay its fair share of taxes under the simple tax?

A: Only people pay taxes. The simple tax is designed so that income from business sources is taxed at the same rate as income from employment. Under the current system, some

business income is taxed at excessive rates because of the double taxation of corporate dividends. Other business income is lightly taxed or even subsidized through tax shelters.

Q: Isn't the tax unfair because rich people can live off interest and capital gains income and thereby pay no taxes?
A: Not at all. In effect, the simple tax puts the equivalent of a withholding tax on interest and capital gains. The business tax applies to business income before it is paid out as interest, or if it is retained in the business and generates capital gains for stockholders. The interest, dividends, and capital gains received by the rich have already been taxed under the business tax. The rich cannot escape the tax.

Q: Won't part of the tax on capital be shifted onto consumers in the form of higher prices rather than being paid by the owners of the capital? Isn't this unfair relative to the compensation tax, which will not be shifted?
A: Yes. There is a fundamental difference between capital, which is a produced input, and labor, which is a primary, unproduced input to the economy. Because it permits first-year writeoff of investment, the simple tax puts no tax on the marginal addition to capital--the tax benefit of the writeoff in the first year just

counterbalances the taxes that will be paid from its productivity in the future. For this reason, the tax is not actually shifted forward. On the other hand, all of the growth in the revenue from the simple tax comes from growth in the size and real incomes of workers. It is not an issue of equity but rather of economic reality that all taxes bear fundamentally on labor income. The simple tax embodies the right incentives for people to save labor income to form capital.

Q: Isn't it unfair not to tax capital gains received by individuals?

A: Capital gains are taxed under the simple tax. Capital gains from the sale of a business property--an office or an apartment building, or a house held for investment purposes--would be taxed under the business tax, which treats the proceeds from the sale of plant, equipment, and buildings as taxable income for the business. Capital gains on stocks, bonds, and other financial instruments arise from the capitalization of after-tax income; it would be double taxation to tax the capital gain as well. Capital gains on owner-occupied houses arise from the capitalization of rental values which are heavily taxed by state and local governments; again, it would be double taxation for the federal government to tax the capital gain as well.

Q: Why does the simple tax collect the business tax from the firm and the compensation tax from the worker? Wouldn't it be more consistent to collect both from the firm or both from the individual?

A: The nation's experience in trying to collect income taxes on interest and dividends from individuals has been dismal. One of the huge advantages of the flat-rate simple tax is that it permits airtight collection of taxes on business income at the source, where enforcement is easiest. On the other hand, requiring individuals to fill out the compensation form is necessary to provide the benefits of the personal allowance to each taxpayer. The tax withholding system already in operation would be adapted to permit the collection of most of the compensation tax from the employer, so that taxpayers would not be faced with a large single tax payment at the end of the year.

The business tax

Q: What would happen to the unused depreciation deductions from capital investments made under the old tax system?

A: These deductions would simply be lost. In the first place, much lower tax rates make the deductions much less important--reduced taxation of the earnings of capital completely offsets the decline in the value of the

deductions because of lower tax rates. In the second place, the existing combination of an investment credit taken at the time of purchase and accelerated depreciation for tax purposes means that most plant and equipment has already received most of the tax benefits; eliminating the remaining depreciation would not impose an important burden on business.

Q: I'm a travelling salesman. I earn commissions and pay my own travel expenses. I do not receive a salary. How would I fill out the simple tax?

A: All self-employed individuals will file the business tax form, where they can deduct business expenses. In order to take advantage of the personal allowance, you will want to pay yourself a salary of at least, say, $5000 if you are married. Report this amount along with your wife's earnings on your compensation tax form. In this way, you will be able to deduct your legitimate business expenses and receive the personal allowance.

Q: Please explain how the current system taxes income twice. Isn't income income no matter what its source?

A: Income is an individual's command over resources. Only people have income. The income of a corporation is just the income of its owners, the stockholders. The current tax system sometimes taxes the same income twice, once when the corporation receives it and again when it is paid as

dividends to the stockholders. The combined tax rate on the stockholder's income is almost confiscatory, even though the two separate taxes are at rates of around 50 percent.

Q: How are tax losses for individuals and businesses treated?

A: Remember that the self-employed fill out the business tax form just as a large corporation does. Business losses can be carried forward without limit to offset future profits. There is no such thing as a tax loss under the compensation tax. You can't reduce your compensation tax by generating business losses.

Q: Would a company going bankrupt get a tax refund in proportion to its loss?

A: No. The simple tax would never make payments to taxpayers. However, a bankrupt company could be acquired by another firm, which would assume the tax loss.

Q: Some companies pay so much interest today that requiring them to pay the business tax (which does not permit the deduction of interest) would make them operate at a loss. Is this appropriate?

A: This is an aspect of the transition to the simple tax. Corporations and homeowners with large amounts of debt will suffer, just as those with large holdings of bonds or

mortgages will gain. For two reasons, the problem will not be too serious. First, the dramatic reduction in the tax rate to 19 percent will more than offset the increase in taxes from the loss of interest deductions in most cases. Second, most corporate debt can be called and reissued at lower rates as soon as the simple tax goes into effect.

Q: If a firm plowed back all of its income into plant and equipment, and hence paid no business tax, couldn't the firm increase its value forever without paying taxes? Wouldn't the stockholders receive the capitalized value of the firm as untaxed capital gains?

A: Sooner or later, the firm will run out of sufficiently profitable opportunities and will start paying out its income to its owners instead of plowing it all back. If the market didn't believe this, the stock would have no value, because the stockholders would not believe that they were every going to get anything. The market will always know that the tax will be imposed on any returns earned by the stockholders, so the market value of the firm will always be the capitalized value after taxes.

Q: Won't businesses constantly buy and sell equipment in order to take advantage of the immediate writeoff?

A: There is nothing to be gained from extra purchases and sales. The proceeds of a sale of equipment must be reported as income, and offset the tax benefits of a

subsequent purchase.

Q: How are individuals taxed on their rental activities? Is rental income part of individual compensation or business income? Would individuals have to file both business and individual tax forms if they had both kinds of income?

A: Renting is definitely a business activity and would call for a business tax form. Rental receipts are taxed as business income, but purchase of a rental unit qualifies for first-year writeoff. Because there are no complicated depreciation computations, very little effort would be required to fill out the business tax form for a rental unit.

Q: If a company provides its employees with subsidized lunches, physical exercise facilities, company cars, and the like, how are these treated under the simple tax?

A: Fringe benefits cannot be deducted as expenses under the business tax. Of the firm's expenditures for the purpose of attracting and keeping workers, only those paid directly to the worker and reported for the purposes of the individual compensation tax are deductible for the company.

The compensation tax

Q: With the current income tax, my fringe benefits aren't taxed. Your simple tax doesn't tax fringes either, but it does not permit my employer to deduct them. What will happen to my fringe benefits under the simple tax?

A: Your fringe benefits are one of the features that attracted you to your job, and your employer will not want to cut them without compensating you in some other way. The simple tax eliminates the distortion toward fringe benefits created by the present income tax, so you can expect that your employer will offer you reduced fringes in exchange for higher pay, which you can use to buy the benefits yourself or for any other purpose.

Q: My teenage daughter has taken a part-time job and will earn about $1000 this year. Can she use the personal allowance of $3800 to avoid paying tax? Will I lose my dependent's allowance of $750 for her?

A: All taxpayers are entitled to the personal allowance, including your daughter. You will retain the dependent's allowance as long as you provide more than half her total support over the year.

Non-profit organizations

Q: How does the simple tax treat non-profit organizations like cooperatives that pay dividends?

A: They are exempt from the business tax, but their employees must pay the individual compensation tax. As under present law, their dividends are untaxed. Note that non-profit organizations cannot benefit from the investment incentive of first-year writeoff either.

Q: What about non-business entities such as trusts, estates, or charitable organizations including churches and schools?

A: Any actual business owned by one of these entities must file the business tax form. Their employees must pay the individual compensation tax. Otherwise, they are not taxed. Note that a conventional personal trust, which holds stocks and bonds, deals entirely in after-tax income and there is no reason for the tax system to pay attention to it.

Inheritance tax

Q: What about the inheritance tax?

A: We do not believe that an inheritance tax is necessary under a system with watertight comprehensive taxation of income.

Q: Wouldn't it be a good idea to broaden the tax base by including gifts, life insurance proceeds, inheritances, and

so forth?

A: No. The base for the simple tax is carefully chosen to provide the most efficient economic incentives. Further broadening to the listed items would be double taxation. Gifts represent the transfer of income that has already been taxed and there is no reason to tax it again. Life insurance proceeds are a mixture of interest earnings, which have already been taxed by the business tax, and return of premiums, which again were paid from income already taxed. Inheritances are just a special form of gifts.

Economic and social benefits

Q: How will the simple tax change the spending and savings patterns of individuals and businesses?

A: The improved, uniform investment and savings incentive provided by universal first-year writeoff will channel capital into its most productive uses. Equalization of tax rates across taxpayers will prevent the widespread abuse of tax shelters which divert savings from their efficient destinations. Dramatic reductions in marginal tax rates will stimulate investment and work effort, and draw activities out of the underground economy and into the more efficient market economy.

Senator JEPSEN. It is my understanding that we would agree to proceed and have the other panel members testify, and then we'll have questions.

Before we recognize Mr. Minarik—I understand this is Mr. Ture—which one of the two of you wishes to go next?

Mr. TURE. It is your pleasure, sir.

Senator JEPSEN. We'll start with Mr. Minarik.

Just so we understand, Mr. Hall, and without your saying so, but what you said over and over again is that we have two sets of tax laws under our current situation, one for those who plan and one for those who don't; and if you plan under our present tax structure, you can legally avoid—I'm not talking about evading now, there's a difference in evading and avoiding—you can legally avoid taxes and at least postpone through generations; is that correct?

Mr. HALL. That is absolutely right, Senator.

Senator JEPSEN. And, therefore, the rich get richer and the poor get poorer, and those who can afford the very best in counsel and have access to these things—and that's where we get the foundations and all those good things you have where millionaires pay no taxes at all, that's because of the planning that is able to be done now because of our present tax structure.

Your proposal says you take and you make it simple, so that you avoid all of that possibility; is that what you are saying?

Mr. HALL. That is a fair summary.

Senator JEPSEN. Mr. Minarik.

STATEMENT OF JOSEPH J. MINARIK, DEPUTY ASSISTANT DIRECTOR, TAX ANALYSIS DIVISION, CONGRESSIONAL BUDGET OFFICE

Mr. MINARIK. Mr. Chairman, I have two statements. I wrote one when I was invited to testify here. I was under the impression that it was going to be a general hearing. I discovered last week that there was going to be a lot of time spent on the Hall-Rabushka proposal; so, I spent some time this weekend preparing a separate statement directly in address to their proposal. Unfortunately, time is a little short this week, and I haven't completely had it produced. I do have a summary which I would like to read into the record; and then, with your consent, I'd have this——

Senator JEPSEN. I would advise all the panel members that any statements that they have in writing will be entered into the record.

And you may proceed in any way that you so desire.

And what did you think it was going to be, a "gentle hearing"? [Laughter.]

Mr. MINARIK. "General."

Like just about everything else in this imperfect world, the flat-rate income tax has its advantages and its disadvantages. The best way to analyze the flat-rate tax—defined as a tax levied at a single rate on an income base broader than that of current law—is according to the three long-standing criteria for all taxes, economic efficiency, simplicity, and fairness. However, it is important to distinguish between the two components of the flat-rate tax, the single rate and the broader base, in performing the analysis.

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In terms of economic efficiency, a broader tax base would have many advantages. If all income were taxed alike, resources would be allocated to their best uses and the currently high marginal tax rates on nonpreferred income could be reduced.

On the other hand, it is unclear how much additional economic efficiency would be added to a broadened-based income tax by using a flat rate instead of graduated rates. It is sometimes alleged that tax rate progressivity discourages work, saving, and investment, and that a flat rate would solve this problem. In fact, however, it is the level of the marginal tax rates, not the fact that they are progressive, that reduces incentives. A simple, although admittedly extreme example, should make this clear.

One could imagine a progressive income tax with 10 tax-rate brackets ranging from 1 to 10 percent. It would have little or no disincentive effect. But a flat-rate tax with a 50-percent rate might have considerable disincentive effects. Thus, what determines the efficiency cost of any income tax is the level of the rate or rates, which, for a given revenue, is determined by the size of the tax base. So, it is the base broadening that probably has the real effect.

Using a flat rate would unquestionably raise lower income people's marginal tax rates and lower those of high-income taxpayers. To collect the same total revenue on the same tax base with graduated rates, the bottom-bracket rates could be made lower but the top rates would have to be higher to make up for the resulting revenue loss. So, the flat rate is going to be somewhere in the middle.

The net effect on incentives is thus very hard to predict, especially if the flat rate tax shifts the tax burden from upper- to lower-income groups before the taxpayers actually respond by changing their behavior. To illustrate: A high income self-employed professional divides his time between working and vacationing. A flat rate tax is enacted, his marginal tax rate falls from 50 to 19 percent, but he also receives a $20,000 tax cut. Does he work more to take advantage of his higher after-tax wage, or does he use his extra $20,000 to finance longer and more expensive vacations? Economists have found these counteracting incentives in plausible tax policy changes to very nearly cancel each other out.

So, it's useful to distinguish between the efficiency effects of broadening the tax base and those that apply to a flat tax rate. If all else is equal, using a flat rate would permit reducing some marginal tax rates only at the expense of raising others. On the other hand, broadening the tax base would permit the reduction of all marginal tax rates.

In terms of simplicity, the effects of the broader base are mixed. The tax law and forms are simplified if deductions, credits, or partial exclusions are repealed. However, taxing incomes that were heretofore untaxed complicates the tax system, particularly when valuation problems arise, such as in the taxation of nonwage employee compensation, or social security benefits. Changing to a flat tax rate does not add significantly to any simplification from base broadening. Taxpayers will still look up their tax liabilities on tax tables, the way they do now, and the IRS computers really couldn't care less how many tax rate brackets there are.

The tax simplification that is feasible with a broad tax base and a flat tax rate is really very limited, and should not be oversold. Pro-

fessors Hall and Rabushka have come up with a very different kind of flat rate tax system that raises its own issues; and I'd like to discuss that a little bit later.

Fairness is a subjective concept, and opinions on the fairness of any tax system will inexitably differ. Some people would argue that a broader tax base is more fair; if there were no tax preferences, those with the best advice and the most resources could no longer use elaborate schemes to cut their tax bills. Others might quarrel, however, with the elimination of widely used preferences like the mortgage interest and charitable contributions deductions.

Opinions will also differ on the fairness of using a flat rate instead of graduated rates. Some will argue that a flat rate is the essence of fairness; every taxpayer pays the same share of his income in tax. Others will counter that people with higher incomes buy nonessentials with their last dollars of income while those with lower incomes buy the basics. Therefore, they would reason, people with higher incomes have a greater ability to pay taxes and should pay higher marginal tax rates. We will not settle this argument today or at any other time.

The only polling evidence I have ever seen suggests that a majority of the American people favor progressivity. An account of that poll is appended to my statement. But that may not be the last word.

One aspect of fairness that we can quantify is how the flat rate tax would change current law tax liabilities. Table 1 in my prepared statement shows the distributional effect of four different flat rate tax systems, all designed to yield the same revenue as the 1984 tax law at 1981 income levels. Without going into painful details, the unavoidable conclusion is that the flat rate tax, however it is designed, will reduce the tax burden of taxpayers with the highest income and will increase the tax liabilities of middle income taxpayers.

The explanation of these redistributive effects and of their immunity to change is relatively simple. The tax system that we have now, for all its exclusions and deductions, is somewhat progressive. Under 1984 law taxpayers with six-figure total incomes, that is of $100,000 and over including long-term capital gains in full, will pay about 25 percent of their total incomes in tax. It follows, then, that any flat tax at a rate below 25 percent will cut taxes for those with incomes of $100,000 and up.

If the flat tax is to maintain current law revenues, that tax cut for upper income taxpayers must be made up by those with smaller incomes. If the flat tax protects very low income taxpayers with larger personal exemptions or standard deductions, then they get a tax cut, too. Again, the middle income taxpayer has to pick up the slack. So, under the flat rate tax, the average taxpayer gets squeezed from both ends.

I'd like to move on to a discussion of Professors Hall and Rabushka's proposal. I have had a little bit of time on the phone with Professor Rabushka, not an awful lot. And some of the things that I say, therefore, will have to be tentative. And also, I'd like to revise my written statement when I have a chance to see their comments.

First of all I think Professors Hall and Rabushka should be congratulated for coming up with what I think is a very interesting new twist in the attempt to implify the tax system. A large part of what they do in simplifying the tax system comes through eliminating what

we call the double taxation of dividends. That is an objective that some people would find attractive and some people wouldn't. Hall and Rabushka have found a way to use that objective in order to simplify the tax system fairly dramatically.

I do have one little quibble with the way they go about it, and it is not something that one could do anything about. But it is clear that the taxation of corporate dividends under their system is done at the corporation's ability to pay, not at the individual's ability to pay. So, for example, an elderly retiree who lives on dividends receives after tax dividends, whereas under a conventional integrated system, which would be much more complex than what they propose, that individual would receive pretax dividends and could use his standard deduction and personal exemption so as not to pay tax.

With the end of double taxation of dividends, plus elimination of taxation of capital gains, gifts, and bequests, and the low flat rate on individual and corporate income, Hall and Rabushka would clearly reduce the tax burden on capital substantially. Because they would also maintain the current tax yield, it follows that they would raise the tax burden on labor by an equally substantial amount.

My own distributional estimates, which must be tentative, show that the tax liabilities of the typical middle income single persons and families would be increased. The single person with a $15,000 wage or salary income would pay 14 percent more under Hall and Rabushka than under 1984 law. Four-person families with incomes of $25,000, $35,000, and $45,000 and typical itemized deductions would pay 43 percent, 22 percent, and 11 percent more, respectively, under Hall and Rabushka. In contrast, taxpayers with very high incomes would enjoy substantial tax cuts. Those with adjusted gross incomes between $100,000 and $200,000 would receive tax cuts of about 45 percent on average. Those with incomes over $1 million would have their taxes cut by about 85 percent. When these tax liabilities are increased to account for Hall's and Rabushka's different treatment of dividend and interest inome—an adjustment that may or may not be considered valid by any particular analyst—the tax cuts are still quite large, at 35 percent for the $100.000 to $200,000 income group and over 70 percent for those over $1 million.

The Hall-Rabushka proposal retains many of the efficiency characteristics of all flat rate taxes, as described in the main body of my statement. However, there are other aspects in which Hall-Rabushka is quite different.

As was noted earlier, there is a substantial shift of tax burdens from capital to labor. One aspect of this shift is Hall-Rabushka's requirement that employers pay the 19 percent business tax on all forms of nonwage compensation: the social security and unemployment taxes, workers' compensation costs, and contributions to pension funds and life and health insurance programs.

For high wage employees, these costs will be shifted backward from the emplover to the employee in some way; so the employee will bear the tax, and most likely the tax increases of middle income households I described earlier will in fact be larger.

For lower wage workers, the tax on unshiftable costs—social security, unemployment taxes, and workers' compensation—will increase the employers' cost like an increase in the minimum wage. Some of these workers may find themselves priced out of the market.

Other features of the Hall-Rabushka proposal will have sharp impacts on particular sectors of the economy. Eliminating the tax deductability of interest would hurt, particularly, businesses that borrow to carry inventory. Prohibiting the deduction of any unused depreciational allowances on the date the proposal takes effect would have a capricious, negative effect on any firm that has recently made any long-lived investments. It would also cause a strong incentive to postpone investment as the effective date of the proposal approached.

A combination of a tax on nonwage compensation, the repeal of the deductibility of interest, and the elimination of unused depreciation allowances would impact heavily on industries such as the wholesale and retail trade which are labor intensive, borrow to carry inventory, and use long-lived capital. Eliminating use of preexisting net operating loss carry forward and unused investment credits would hit particularly hard at struggling firms.

A final general area to be examined is Hall-Rabushka's estimate of the revenue yield of their proposal. The attractiveness of the proposal is, in part, a function of the low tax rate, 19 percent. And so it is important that the system yield the revenues claimed at that rate.

Estimating tax revenue from the national income and product accounts [the "N.I.P.A.'s"] as they do, is a difficult and perilous activity. And I believe that Hall and Rabushka fell into some traps. They included in their tax base all nonwage compensation paid in the economy. I believe that they neglected to consider that some of that nonwage compensation is paid by nontaxable entities—governments and nonprofit institutions. So that part of the nonwage compensation would not be reachable by their tax as it exists now.

Also, where Hall and Rabushka propose to tax foreign-owned firms located in the United States, and not to tax U.S.-owned firms overseas, they estimate their revenues as if they were doing just the reverse; that is, they include in their tax base the rest of the world component of the gross national product, which is U.S. income from overseas minus the income of foreign-owned firms in the United States. The effect of correcting these two inconsistencies is to reduce the Hall-Rabushka tax base by just over $100 billion at 1981 levels of income. That would require that their tax rate be increased from 19 to 20 percent.

In another area Hall and Rabushka leave in their tax base some income items that have always been assumed very difficult if not impossible to tax. These include: business write-offs of bad consumer debts, liability for injuries, the free services provided by banks and other financial intermediaries to consumers, food and fuel produced and consumed on farms, and free meals, clothing, and lodging provided to employees. If these incomes were judged administratively infeasible to tax, the tax base would be reduced by about another $50 billion, and the tax rates would have to increase by another one-half point.

The Hall-Rabushka tax base estimate may also be optimistic because of this assumption regarding the underground economy. Hall and Rabushka explicitly assume that all the income included in the national income and product accounts would be reported for tax purposes. However, current income tax reporting runs billions of dollars short of NIPA estimates. The estimates of the shortfall in reporting in 1978 was about $100 billion. Therefore, if much of the underground

economy does not come to the surface through the Hall-Rabushka plan, and as was noted earlier Hall and Rabushka would ask the taxpayers at middle-income levels to pay more than would be due under current law, they would not collect as much revenues as they predicted.

Finally, if the Hall-Rabushka transition devices—the cutoff of unusual depreciation allowances, net operating losses, and investment tax credits—were not accepted, the revenue yield would not be as much as was predicted.

In sum, Hall and Rabushka have devised a clever means of simplifying the individual and corporate income taxes, while eliminating the double taxation of dividends through the flat rate tax. This simplification has the side effect of increasing the tax burden of middle-income taxpayers and reducing it on upper income taxpayers. So, in some sense, the simplification and redistribution of the tax burden constitutes a trade off. The proposal would increase the tax burden on labor and the cost of labor in the private sector, while reducing the tax burden on capital. It could have some sectoral effects within the economy, and could bear heavily on firms that are currently marginally profitable or unprofitable.

The revenue estimates of the proposal may be optimistic for several reasons, and it is possible that the planned tax rate would have to be raised by 1½ percentage points or more.

I'd like to close, again, by complimenting Professors Hall and Rabushka on what I think is really an inventive and fascinating approach to the simplification of the tax system. I know they're still working on their proposal, and I'm sure that they will continue.

[The prepared statement of Mr. Minarik, together with a supplement, follows:]

Prepared Statement of Joseph J. Minarik

Like just about everything else in this imperfect world, the flat rate income tax has its advantages and its disadvantages. The purpose of my testimony today is to outline some of the pluses and the minuses for the Subcommittee. But before we can examine the flat rate tax, we need to define carefully what we mean.

For the purpose of this statement, the flat rate income tax is a single rate tax on an income base broader than that of current law. As the numerous self-described flat tax bills make clear, many approaches fit this general description. It is also evident that one could introduce a flat tax rate without broadening the tax base, or vice versa. This latter distinction is important; even if you should decide that a single tax rate is not the best approach, we would still have other things to talk about today.

To analyze the flat rate tax, it is helpful to separate the effects of the base broadening from those of the flat rate itself. The first part of my testimony will deal with the pros and cons of broadening the tax base. The second part will incorporate the single tax rate into the analysis.

BROADENING THE INCOME TAX BASE -- GOALS AND POSSIBLE EFFECTS

The current interest in the flat rate tax has brought along with it renewed interest in broadening the tax base. The idea of "closing loopholes," "repealing tax expenditures," or "broadening the tax base" -- whichever one chooses to call it -- is certainly not new. It is the core of a school of thought of tax policy that used to be called "tax reform" and was identified more than any other influence with the Tax Reform Act of 1976. The Senate Finance Committee included several base broadening steps in its recent tax bill.

As the Subcommittee will hear many times before its hearings are over, the three goals of any tax system are efficiency, simplicity, and fairness. These goals have been universally recognized for decades, and it is not surprising that they should be widely cited in the current debate. This section next will analyze base broadening according to these three criteria.

Efficiency

A broad tax base has long been thought a necessary condition for efficient taxation. The current legal definition of "gross income" thus includes ". . . all income from whatever source derived . . ." (Section 61a); but over recent years many exceptions have crept into the law. These exceptions reduce economic efficiency in two ways.

First, if the income from some particular economic activity is either excused from taxation, or taxed at some preferential rate, then that activity is more attractive to taxpayers. Resources will flow into the tax-preferred activity from other activities with higher pretax returns, with the result that the real value of the economy's output is reduced. Everyone but the direct beneficiaries will be worse off in the long run. Some observers would argue with this generalization, on the grounds that society sometimes errs in its preferences; for example, they might say that people are shortsighted, and so we need a tax preference for retirement savings. Those who believe in the desirability of free markets, however, would prefer the marketplace to any political judgment of what activities to encourage.

A second efficiency cost occurs when these exceptions to the tax base begin to multiply and grow. As tax-preferred income increases as a share of the total and fully taxed income therefore shrinks, the tax rates needed to meet the government's revenue needs rise. Therefore, the after-tax reward for all non-tax-preferred activities -- which generally includes work and much of saving -- falls. The incentive for socially productive economic activity is reduced, and some unproductive investments (or "tax shelters") use particular tax preferences to earn risk-free after-tax profits.

The solution to these problems of economic inefficiency is to broaden the tax base by repealing the tax preferences for the various heretofore favored types of income and expenditure. Without the tax preferences, resources would be allocated according to the before-tax social return, and marginal tax rates could be reduced.

Base broadening steps must be considered carefully, however. The Congress might be asked to give up the use of tax preferences in the pursuit of some socially desirable goals: saving for retirement is an example. Also, it would be essential to retain in the law those deductions that are necessary to measure income correctly. Failure to keep such provisions would result in an income tax on more than some people's income, causing possibly serious distortions. For example, an income tax on a small businessman that does not allow a deduction for the depreciation of his business computer or other office equipment would require him to pay tax on receipts that merely cover legitimate business expenses. The same could be said of denying an interest deduction to a businessman who borrows to carry inventory. In the

extreme, such excessive base broadening could result in the assessment of an income tax on a business that only breaks even, or even one that loses money. The end result would be to discourage business undertakings in which the nondeductible expenses are important. So, while broadening the tax base generally increases economic efficiency, this benefit is lost if the tax base is broadened beyond the measure of true economic income.

Simplicity

Broadening the tax base is often portrayed as the ultimate simplification of the income tax. Eliminating all those loopholes, some would argue, could trim the size and complexity of tax returns radically and put all the tax lawyers and accountants out of work. But these effects may not be so clear-cut.

It is certainly true that repealing some tax expenditures would simplify the tax forms. Prohibiting itemized deductions, for example, would eliminate Schedule A and obviate the need for keeping records on medical expenses, charitable contributions, and so on. Likewise, repealing the energy conservation credits would eliminate Form 5695 and the need for carrying conservation expense figures from year to year. Taxing long-term capital gains in full would end the complex distinction between long- and short-term gains. In general, repealing deductions, credits, and partial exclusions would simplify the tax filing process. (Increasing the zero bracket amount, which used to be called the "standard deduction," also simplifies tax filing for taxpayers who no longer need to itemize their deductions.)

Not all base broadening steps would simplify the tax system, however. In particular, taxing any type of income that is now exempt from taxation would complicate the system. For example, taxing employers' contributions for employees' life and health insurance premiums would add lines to the tax forms and would force employees to come up with cash to pay taxes on income they did not receive in cash. Taxing employers' pension contributions would be even more complicated for a number of reasons: employees whose pension rights were not vested would have to be treated differently from those who were vested; a transition would be necessary when vesting occurred; and employees who were covered by defined benefit plans might in fact receive rights to future income that differ in present value from the current amount of contributions. Putting "floors" under these items -- that is, making some small amount tax exempt but any excess over that amount taxable -- would complicate the system still further. Taxing all or part of social security benefits would force many of the low-income elderly who are now excused from filing to fill out the tax forms; this would add to the paperwork load of the system. The list could go on and on.

So in terms of simplicity, broadening the tax base could help or hurt, and probably would do some of both. It is unavoidable that some of the complexity of our highly developed economy is reflected in our tax system. We can achieve utter simplicity in our tax laws only by disregarding many very relevant aspects of the real world.

Fairness

Fairness is one of the objectives of base broadening most often mentioned. Tax preferences for ostensibly unimpeachable purposes can sometimes be used simply for tax avoidance by people with some control over their financial affairs, while other taxpayers with less resources or inferior advice cannot take such advantage. The result has been a widespread questioning of the integrity of the tax system and possibly even a reduction in voluntary compliance. Eliminating the tax preferences that can cause extreme differences in tax burdens among similarly situated taxpayers could help to restore confidence in the fairness of the tax system.

One has to consider some caveats to the fairness effects of base broadening as well. Some variation in tax burdens within income groups occurs today not because of manipulative tax avoidance by sophisticated investors but because of such everyday activities as home purchasing and charitable giving. Eliminating those tax preferences would narrow the variation in tax burdens, but it could also have detrimental side-effects. The tax incentive for charitable giving -- a provision meant to benefit society -- would be ended. Home values would fall, and the tax burdens of homeowners would rise. This last effect might be particularly painful, because homeowner deductions are tied to long-term contractual mortgage obligations, and many homeowners would therefore have limited flexibility in their family budgets to absorb the resultant tax increases in the short term.

So in general, base broadening can yield substantial efficiency, simplicity, and fairness benefits; but those benefits must all be qualified to some extent. The

efficiency case for base broadening is very strong, in that eliminating tax influences in the marketplace would cause resources to be allocated to their best uses and marginal tax rates to be reduced; but it would be necessary to retain deductions required for a true measure of income. Eliminating deductions and credits would simplify the tax system, but adding hitherto missing income items to the tax base would complicate the system. Finally, fairness suggests that all income be taxed in the same way, but some persons who are by no means abusers of the current system -- such as homeowners -- might find the elimination of tax preferences distinctly unfair. Others might wish to retain the many tax subsidies for particular socially desirable activities. The lesson from all of this -- unsatisfying though it may be -- is that easy answers are hard to come by; one has to broaden the tax base with care.

With this background on the broadening of the tax base, how does the use of a single tax rate in the current flat rate proposals affect the picture?

A SINGLE TAX RATE -- GOALS AND POSSIBLE EFFECTS

As I noted at the outset, the effects of broadening the income tax base and of changing to a single tax rate can be logically separated. A close examination suggests that some of the effects of base broadening have been attributed to the flat tax rate, while other effects of the flat tax rate have been exaggerated or misunderstood. The flat rate can be evaluated according to the same three criteria as was base broadening: efficiency, simplicity, and fairness.

Efficiency

It is sometimes alleged that tax rate progressivity discourages work, saving, and investment, and encourages tax sheltering; from this standpoint, a changeover to a flat rate is a solution to these problems. In fact, however, it is the level of the marginal tax rates -- not the fact that they are progressive -- that reduces incentives. A simple though admittedly extreme example should make this clear. One could imagine a progressive income tax with ten tax rate brackets ranging from 1 to 10 percent that would have little or no disincentive effect on taxpayers. On the other hand, a flat rate tax with a 50 percent rate might have considerable disincentive effects. Thus, what determines the efficiency cost of any income tax is the level of the rate or rates, which, for a given revenue, is determined by the size of the tax base. How low the marginal rates can be made in any specific tax system, be it flat rate or progressive, is an empirical question.

Using a flat tax rate would unquestionably raise lower-income people's marginal tax rates and lower those of high-income taxpayers. (To collect the same total revenue on the same tax base with graduated rates, the bottom bracket rates could be made lower, but the top rates would have to be higher to make up the resulting revenue loss.) The net effect on incentives is thus very hard to predict. The outcome is even more uncertain if the flat rate tax shifts the tax burden from upper- to lower-income groups before any taxpayers actually respond by changing their behavior. In that case, the marginal rate change (in technical terms, the "price effect") and the tax liability change (the "income effect") would give taxpayers opposite incentives, making the result even more ambiguous.

(To illustrate: A high-income self-employed professional divides his time between working and vacationing. A flat rate tax is enacted; his marginal tax rate falls from 50 to 19 percent, and he also receives a $20,000 tax cut. Does he work more, to take advantage of his higher after-tax wage? Or does he use his extra $20,000 to finance longer and more expensive vacations? Economists have found these counteracting incentives from plausible tax policy changes very nearly to cancel each other out.)

Some improvements of economic efficiency would be caused solely by the flat rate tax; the advantages of tax shelters that move taxable income from high- to low-income years and from high- to low-income taxpayers would be reduced, and complicated court cases in these areas would be less numerous. However, these tax shelter effects stand to influence a more restricted group than the changes in marginal tax rates.

To sum up, it is useful to distinguish between the efficiency effects of broadening the tax base and those of applying a flat tax rate. If all else were equal, using a flat rate would permit reducing some marginal tax rates only at the expense of raising others. On the other hand, broadening the tax base would permit the reduction of all marginal tax rates.

Simplicity

Taxing all of income at a flat rate would simplify the income tax in some respects. Use of a single rate would eliminate the need for the tax rate schedules -- Schedules X, Y, and Z at the end of the Form 1040 instructions (example attached);

filers of any type of return (married filing jointly, married filing separately, single, and head of household) would pay the same tax rate. These schedules are now used only by taxpayers with incomes of above $50,000. Also, the income-averaging option -- now used by about 6 percent of all taxpayers -- could be repealed, because taxpayers would no longer pay higher taxes because of the effect of progressive tax rates on fluctuating incomes. Finally, the number of tax-shelter court cases in some areas would shrink somewhat.

Beyond these changes, however, any further simplification from using a single tax rate would be extremely limited. A brief discussion should indicate why.

One claim sometimes made is that a flat tax rate would eliminate the need for the many pages of tax tables in the Form 1040 instructions (example attached). The taxpayer looks at these tables for his type of return and income, and is told his precise tax liability. Though it is claimed that taxpayers could easily compute their own tax liabilities under the flat rate tax, taxpayers have proven to be more accurate in looking up their tax on the tax tables than in making the actual mathematical computations themselves. Thus, it is unlikely that the tax tables would be abandoned even under a flat rate tax.

Another claim for the flat rate tax is that it would simplify the tax return enough to fit on a postcard. This claim seems exaggerated. The space on the current tax return for the taxpayer's name and address, his indication of the type of return he is filing, the number and names of his dependents, and his signature already exceeds the area of a large (5 inch by 8 inch) postcard. Using a single tax rate would not eliminate the need for reporting any of these pieces of information.

In fact, broadening the tax base by eliminating deductions, partial exclusions, and credits would remove some lines from the tax forms, and also eliminate some entire forms. But much of the information now called for on the tax forms is needed so that compliance with the law can be checked from the forms themselves rather than from full-scale audits. Income must be broken down on tax forms by source, which takes up space and adds complexity, but without it spot checking for accuracy of reporting would be impossible. Individual items of dividend and interest income must be enumerated, so that information returns from payers can be matched to them. Omitting these complications in the name of simplicity could make enforcement far more difficult and costly.

A final claim concerning simplification through the flat tax rate is a saving of billions of dollars of federal expenditures for tax administration. These claims too might be exaggerated, because the flat tax rate alone (as opposed to low, graduated rates on a broad base) would do very little to ease tax administration. Computers can determine tax liabilities from the amount of taxable income in microseconds, regardless of whether the tax schedule is flat or graduated. Even the maximum potential for savings in tax administration is limited; the entire IRS budget request for fiscal year 1983 was only $6.25 billion, more than $3 billion of which was payment of credits in excess of tax liability and refunds of interest on overpayments. In other words, closing down the IRS would save only a little over $3 billion. Thus, it is clear that changing to a flat tax rate could save only a small fraction of that figure, at best.

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In sum, a flat tax rate would add little to any simplification that base broadening would permit. Expectations of reduced paperwork and administrative costs attributable to base broadening and a flat tax rate should not be too high.

Fairness.

Fairness is the most visible and yet the most elusive criterion in an analysis of the flat tax rate. Inequity seems to be high on the list of Americans' criticism of the present income tax. But fairness is a subjective quality, not quantifiable by the methods that economists apply in other areas. Opinions on a flat tax's fairness will inevitably differ.

To some people, a flat rate tax is the essence of fairness; every taxpayer pays the same fraction of his income in tax. If low-income relief is allowed (in the form of a personal exemption or a standard deduction), then effective tax rates would actually be somewhat progressive. The flat rate tax also has some structural fairness advantages. It would eliminate the problem of "bracket creep" caused by inflation (though indexing exemptions and deductions, if any, would be needed to make the system more immune to inflation). The flat rate would also eliminate the marriage-penalty-related problem of one spouse's pushing the other into higher marginal tax rate brackets.

Other people believe in progressive taxation, that is, taxation at increasing marginal tax rates as income increases. Arguments for progressivity generally rest on the principle of ability to pay. Taxpayers with higher incomes are assumed to buy nonessentials with their last dollars of income; those with lower incomes are assumed

to buy more basic items. It might follow, then, that persons with higher incomes could afford to pay tax at a higher rate. Putting the argument another way, the subjective value of the last dollar of a rich man's income is taken to be lower than that of a poor man. Judging the relative strengths of opinion for progressivity and proportionality is difficult. Though a majority of the population appears to favor progressivity on grounds of fairness (58 percent, according to a recent Harris poll, attached), there is probably no agreement within that majority as to just how progressive the tax system should be. On the other hand, the flat rate tax concept is a convenient rallying point for advocates of proportionality. In any event, finding strong support for any particular kind of tax system in heretofore revealed public opinion seems difficult -- given the many diverse options even for the exact design of a flat rate system.

Distinct from the question of fairness in the abstract is the unavoidable comparison of any flat rate tax proposal with current law. A flat rate tax that appeared fair in isolation might increase the tax liabilities of many relatively vulnerable taxpayers. A changeover to a flat rate tax, then, could involve a painful transition in which the "losers" would have to tighten their belts. Policymakers are therefore to some extent prisoners of the current tax law; it might be painful to impose substantial tax increases on persons with modest incomes even for a tax system that, in the abstract, seemed attractive. Of course, the severity of the transition problem for any particular flat tax proposal cannot be assessed according to any general principle; the only way is to make some necessary computations.

It is also important to understand the nature of such a winners-and-losers comparison. There is an almost universal agreement that the federal budget is far from balanced now and will be in near term. Therefore, it seems reasonable to assume that any tax proposal should at least equal the revenue yield of the current law. It then follows, regretably, that any changeover to a flat rate tax (or any other new tax system for that matter) is a "zero sum" game. For every dollar by which one taxpayer's liability is reduced, another taxpayer's liability must be increased by one dollar to keep the revenue total constant. (Some arguments that the flat tax reshuffling is not a zero sum transfer, and some caveats, will be discussed shortly.)

Analysis of Revenues and Distributional Effects of Four Flat Rate Taxes. With this background, Table 1 shows tax liabilities, by income class, for four different hypothetical flat rate tax systems. Each of these tax systems is designed to match the yield of the current tax law with 1984 rates at 1981 levels of income. The tax liabilities in each income group under these flat rate taxes can be compared with 1984 law liabilities (also included in the table) to see whether the tax burden is systematically shifted, and if so, where.

Systems 1 and 2 in the table are mainly illustrative to show the extreme outcomes under alternative tax bases. System 1 portrays a very broad tax base; long term capital gains are taxed in full, itemized deductions are prohibited, and the zero bracket amount and personal exemption are repealed. System 1 is thus a tax on gross income. In contrast, System 2 is simply a flat rate tax on the current law's rather narrow base. Predictably, the broad-based System 1 requires a much lower tax rate

than the narrow-based System 2 (11.8 percent as opposed to 18.5 percent); but the distributional effects of the two systems are conspicuously similar. In both, the tax burden is significantly shifted from upper- to lower-income taxpayers; taxes are increased in the $15,000 - $20,000 group by about 30 percent, while taxpayers with incomes between $100,000 and $200,000 have their taxes cut by 40 to 50 percent. The only significant difference is at the extreme lower end of the income scale; System 1, without personal exemptions or standard deductions, hits the lowest-income taxpayers especially hard, though System 2 is not far behind on that score.

The major lessons of Systems 1 and 2 are probably that broadening the tax base is a prerequisite for achieving a low marginal tax rate (System 2's rate is almost 7 percentage points higher than System 1's) but also that greater rflief for low-income taxpayers is probably necessary to mitigate the redistributive effects of a flat rate tax. Systems 3 and 4 move on both of these fronts. Both of these systems maintain the broad income base of System 1, with capital gains taxed in full and no itemized deductions. System 3, however, permits the same personal exemption and zero bracket amount as under current law (a $1,000 exemption, and zero brackets of $2,300 for single people and $3,400 for married couples); System 4 increases the exemption and zero brackets even further (a $1,500 exemption, and zero brackets of $3,000 for single and $6,000 for joint returns). The tax rate under System 3 is 15.7 percent; System 4 requires an 18.7 percent rate.

Despite these changes, the results for Systems 3 and 4 show a general pattern similar to Systems 1 and 2. Again, the tax burden is shifted significantly, in these

instances from the taxpayers with the highest incomes to those in the middle groups. Only the taxpayers with the lowest incomes are protected by the increased low-income relief in System 4. Under System 3, taxpayers in the $15,000 - $20,000 income group pay 19.0 percent more tax on average; those in the $100,000 - $200,000 group pay 33.2 percent less. Under System 4, the increase for the $15,000 - $20,000 group is 7.7 percent, while the $100,000 -$200,000 group gets a 23.1 percent tax cut.

Winners and Losers From the Redistributive Effects. The explanation of these redistributive effects and of their staying power in the face of adjustments to the flat tax system is relatively simple. Under 1984 law, taxpayers with six figure total incomes (that is, incomes of $100,000 and above, including long-term capital gains in full) will pay about 25 percent of their total incomes in tax. It follows, then, that any flat tax at a rate below 25 percent will cut taxes for those with incomes of $100,000 and up; for example, System 4 cuts their taxes by about one-fourth (25 percent minus 18.7 percent, divided by 25 percent).

If the flat tax is to maintain current law revenue yields, as System 4 does, then this revenue loss to those with the highest incomes must of necessity be made up by those with less income. The only way to moderate this effect in a flat rate tax is to increase the personal exemption and standard deduction. These steps reduce the tax liabilities of persons with the lowest incomes but require a higher tax rate, which adds further to the tax burden that the middle-income household must bear. Broadening the tax base more widely could help, but System 4 probably encompasses virtually all of the potential base broadening. Thus, under the flat tax, the average

taxpayer is squeezed from both ends. The flat tax does not have the flexibility of a graduated tax, in which different tax rates can be raised and lowered in combination to ease the problems of creating winners and losers. It is also worth noting that the tax increases for middle-income groups shown in System 4 are averages; some taxpayers face increases greater than the average, and as noted above, among those with above-average tax increases will be typical homeowners.

Some arguments have been raised to suggest that the flat rate tax would be less redistributive than Table 1 suggests. One argument is that the flat tax rate need not yield the desired revenue at current levels of income, because the flat rate system would encourage substantial increases in work, saving, and investment, that taxable incomes would increase, and that tax revenues would thus exceed static estimates. (Therefore, the flat tax rate for System 4, for example, could be lower than 18.7 percent.) This is, of course, the supply-side argument so much in evidence during the consideration of the Economy Recovery Tax Act of 1981 (ERTA). However, even now, with the major supply-side provisions of ERTA in effect for many months (the Accelerated Cost Recovery System, or ACRS, since January 1981; the 20 percent maximum long-term capital gains tax rate since June 1981; and the 50 percent maximum tax rate on interest and dividends since January 1982), we are still trying to learn the precise magnitude of these supply-side effects. The uncertainty might be attributable to any number of extraneous factors, with high interest rates and a preordained cyclical downturn prominent among them. Given the obvious short-

comings of our understanding in these areas, it might be risky to count on supply-side effects to make up a revenue shortfall in a flat rate tax proposal.

Without a lower tax rate and the resulting static revenue loss, however, any flat rate tax proposal would increase the tax burden on middle-income households. No supply-side boost from upper-income taxpayers would remove this tax increase, and so the middle-income groups would still be worse off.

A second argument for a yield greater than conventionally estimated from a flat rate tax deals with the "underground economy" -- income that is earned but not reported to the IRS. This argument holds that current tax evaders would choose to report income earned under a flat rate tax, because the marginal tax rate would be lower, and the extra income from evading taxes would thus be reduced. The Treasury would therefore collect greater receipts, and so the flat tax rate could be lower than conventional analysis would suggest. This argument is more complicated than it sounds, and it must therefore be analyzed with care.

First, though everyone agrees that there is some underground economic activity, no one knows just how much. Estimates presented thus far have been based on extremely speculative methods, have yielded widely varying results, and have been highly controversial. Thus, it might be risky to embrace a tax policy on an assumption that some minimum amount of revenues from underground activity would be captured.

Second, the claim that the underground economy would surface if lower marginal tax rates were imposed is impossible to prove, and the compliance payoff of

marginal tax rate reductions cannot be predicted accurately. One can only guess at the reactions of the unidentified and uncounted persons who take their income "off the books" if marginal tax rates were reduced. Today's participants in the underground economy are concealing their income from the IRS and getting away with it. They might elect to report their incomes if marginal tax rates were lower, because the payoff of tax evasion would be smaller. But if they are successful in evading tax now, and think that they can continue to do so without taking the legal consequences, why should they stop? Perhaps one can only raise the underground economy by persuading the tax evaders that they will be caught if they violate the law. That would require greater outlays for enforcement, not lower marginal tax rates.

Finally, however, it is not at all clear that underground tax evaders would receive marginal rate cuts under the flat rate tax. The marginal tax rate under System 4, for example, is almost 19 percent; a married couple with two children needs an adjusted gross income of $24,200 to exceed a 19 percent rate under 1984 law. But perhaps even more to the point is the total tax burden of middle-income households. As was shown in Table 1, even a flat rate tax with greater low-income relief would raise taxes, not lower them, for the broad middle group of households with incomes from $10,000 to $50,000. How will these taxpayers react to the tax increase? Rather than cause the underground economy to surface, the flat rate tax might drive currently law abiding middle income taxpayers underground and make the underground economy -- and the revenue loss -- bigger, not smaller.

Again, a flat rate proposal of current law yield without relying on revenues from the underground economy might nonetheless claim some of those revenues as a bonus. But still again, unanticipated revenues from the underground will not compensate the middle-income taxpayer for his flat tax increase.

Evaluation of the Fairness Issue. To sum up this discussion of fairness, the flat rate tax might, in the abstract, be preferred to a graduated system by a substantial share of the populace, though a recent poll suggests that the flat rate would fail to garner a majority of support. One problem of the flat rate tax, however, is its reshuffling of tax liabilities in comparison to current law. A flat rate tax would inevitably shift more of the tax burden to middle-income families -- and possibly, depending on how it was constructed, to low-income families as well. If the flat rate tax were to equal the yield of the current tax law, then many middle-income taxpayers would face tax increases in the transition, while upper-income taxpayers enjoyed large tax cuts. Two arguments that a flat rate tax would yield more revenue than conventional analysis would suggest -- supply-side effects and new revenues from the underground economy -- are speculative, and might therefore be shakey grounds for long-range economic planning.

CONCLUSION

The proposals for broadening the tax base and charging a single tax rate have both benefits and costs. Broadening the tax base would result in a more efficient allocation of resources and lower tax rates. / Some base broadening steps would simplify the tax code and forms to some extent, but others would complicate both;

the net balance is hard to predict. Finally, if deductions and exclusions were removed from the tax law and all forms of income were added to the tax base in the same way, many opportunities for tax gamesmanship might be cut off, and the public might have a higher opinion of the fairness of the income tax. There might be transition problems, however, for those who lost their tax preferences, and long-term problems if income were not properly measured.

The use of a single tax rate might have some positive effects but other, ill effects. A flat tax rate, if all else were equal, would raise the marginal tax rate for some taxpayers and lower it for others; whether the result is an efficiency gain or an efficiency loss is difficult to guage. The simplicity gains of a changeover would be minimal and superficial; taxpayers would continue to look up their tax liabilities on tax tables to minimize the likelihood of computation errors, and tax administration through high-speed computers would not be changed noticeably by the single tax rate.

In terms of equity, however, the effects of the single tax rate may be considerable. While, in the abstract, the flat rate may appeal to some people as more fair, in practice it would redistribute a significant share of the tax burden from upper-income to middle-income (and possibly even low-income) taxpayers. Many of these middle-income taxpayers already have limited financial flexibility due to contractual mortgage interest and property tax obligations.

After weighing these advantages and disadvantages of the typical flat rate tax package, the Congress might decide to accept or reject it. In the meantime, however, there is nothing to lose by considering the available options. The benefits

of tax base broadening can be had through a measured approach, without necessarily repealing every deduction and exclusion. The tax rate schedule under a broad based system could be lower than it is now for most taxpayers without being completely flat. This general path has been suggested frequently by many tax analysts for many years.

The tax system is certainly not the only factor, and probably not even the most important factor, that fuels or drags the U.S. economy; but we should certainly do everything we can, using every possible method, to make it more efficient, simpler, and more fair.

1981 Tax Rate Schedules

Your zero bracket amount has been built into these Tax Rate Schedules.

Schedule X
Single Taxpayers

Use this schedule if you checked **Filing Status Box 1** on Form 1040—

If the amount on Form 1040, line 34 is: Over—	But not over—	Enter on line 2 of the worksheet on this page:	of the amount over—
$0	$2,300	—0—	
2,300	3,400	..... 14%	$2,300
3,400	4,400	$154+16%	3,400
4,400	6,500	314+18%	4,400
6,500	8,500	692+19%	6,500
8,500	10,800	1,072+21%	8,500
10,800	12,900	1,555+24%	10,800
12,900	15,000	2,065+26%	12,900
15,000	18,200	2,611+30%	15,000
18,200	23,500	3,568+34%	18,200
23,500	28,800	5,367+39%	23,500
28,800	34,100	7,434+44%	28,800
34,100	41,500	9,766+49%	34,100
41,500	55,300	13,392+55%	41,500
55,300	81,800	20,982+63%	55,300
81,800	108,300	37,677+68%	81,800
108,300	.....	55,697+70%	108,300

Schedule Z
Unmarried Heads of Household

(Including certain married persons who live apart (and abandoned spouses)—see page 6 of the instructions)

Use this schedule if you checked **Filing Status Box 4** on Form 1040—

If the amount on Form 1040, line 34 is: Over—	But not over—	Enter on line 2 of the worksheet on this page:	of the amount over—
$0	$2,300	—0—	
2,300	4,400	..... 14%	$2,300
4,400	6,500	$294+16%	4,400
6,500	8,700	630+18%	6,500
8,700	11,800	1,026+22%	8,700
11,800	15,000	1,708+24%	11,800
15,000	18,200	2,476+26%	15,000
18,200	23,500	3,308+31%	18,200
23,500	28,800	4,951+36%	23,500
28,800	34,100	6,859+42%	28,800
34,100	44,700	9,085+46%	34,100
44,700	60,600	13,961+54%	44,700
60,600	81,800	22,547+59%	60,600
81,800	108,300	35,058+63%	81,800
108,300	161,300	51,780+68%	108,300
161,300	.....	87,796+70%	161,300

Schedule Y
Married Taxpayers and Qualifying Widows and Widowers

Married Filing Joint Returns and Qualifying Widows and Widowers

Use this schedule if you checked **Filing Status Box 2 or 5** on Form 1040—

If the amount on Form 1040, line 34 is: Over—	But not over—	Enter on line 2 of the worksheet on this page:	of the amount over—
$0	$3,400	—0—	
3,400	5,500	..... 14%	$3,400
5,500	7,600	$294+16%	5,500
7,600	11,900	630+18%	7,600
11,900	16,000	1,404+21%	11,900
16,000	20,200	2,265+24%	16,000
20,200	24,600	3,273+28%	20,200
24,600	29,900	4,505+32%	24,600
29,900	35,200	6,201+37%	29,900
35,200	45,800	8,162+43%	35,200
45,800	60,000	12,720+49%	45,800
60,000	85,600	19,678+54%	60,000
85,600	109,400	33,502+59%	85,600
109,400	162,400	47,544+64%	109,400
162,400	215,400	81,464+68%	162,400
215,400	.....	117,504+70%	215,400

Married Filing Separate Returns

Use this schedule if you checked **Filing Status Box 3** on Form 1040—

If the amount on Form 1040, line 34 is: Over—	But not over—	Enter on line 2 of the worksheet on this page:	of the amount over—
$0	$1,700	—0—	
1,700	2,750	..... 14%	$1,700
2,750	3,800	$147.00+16%	2,750
3,800	5,950	315.00+18%	3,800
5,950	8,000	702.00+21%	5,950
8,000	10,100	1,132.50+24%	8,000
10,100	12,300	1,636.50+28%	10,100
12,300	14,950	2,252.50+32%	12,300
14,950	17,600	3,100.50+37%	14,950
17,600	22,900	4,081.00+43%	17,600
22,900	30,000	6,360.00+49%	22,900
30,000	42,800	9,839.00+54%	30,000
42,800	54,700	16,751.00+59%	42,800
54,700	81,200	23,773.00+64%	54,700
81,200	107,700	40,732.00+68%	81,200
107,700	.....	58,752.00+70%	107,700

Caution

You must use the Tax Table instead of these Tax Rate Schedules if your taxable income is less than $50,000 unless you use Form 4726 (maximum tax), Schedule D (alternative tax), or Schedule G (income averaging), to figure your tax. In those cases, even if your taxable income is less than $50,000, use the rate schedules on this page to figure your tax.

Instructions

If you cannot use the Tax Table, figure your tax on the amount on line 34 of Form 1040 by using the appropriate Tax Rate Schedule. Then, unless you use Schedule G or Form 4726, figure your 1981 Rate Reduction Credit (1.25%) on the worksheet below.

Tax Computation Worksheet

(Do not use if you figure your tax on Schedule G or Form 4726.)

1. Taxable income from Form 1040, line 34 . _____
2. Tax on the amount on line 1 from Tax Rate Schedule X, Y, or Z . _____
3. Rate Reduction Credit. Multiply the amount on line 2 by .0125 . . . . . _____
4. Subtract line 3 from line 2. Enter here and on Form 1040, line 35 . . . . . _____

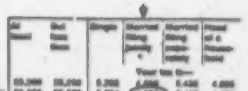
Do not file—keep for your records.

Note: If you use the alternative tax computation on Schedule D (Form 1040), enter the amount from Schedule D, line 32, on line 1 of the worksheet. Complete the worksheet and enter the amount from line 4 of the worksheet on Schedule D, line 33.

1981 Tax Table

Based on Taxable Income
For persons with taxable incomes of less than $50,000.

Example: Mr. and Mrs. Brown are filing a joint return. Their taxable income on line 34 is $23,270. First, they find the $23,250-23,300 income line. Next, they find the column for married filing jointly and read down the column. The amount shown where the income line and filing status column meet is $4,082. This is the tax amount they must write on line 35 of their return.



If line 34 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
0	1,700	0	0	0	0
1,700	1,725	0	0	a2	0
1,725	1,750	0	0	5	0
1,750	1,775	0	0	9	0
1,775	1,800	0	0	12	0
1,800	1,825	0	0	16	0
1,825	1,850	0	0	19	0
1,850	1,875	0	0	22	0
1,875	1,900	0	0	26	0
1,900	1,925	0	0	29	0
1,925	1,950	0	0	33	0
1,950	1,975	0	0	36	0
1,975	2,000	0	0	40	0
2,000					
2,000	2,025	0	0	43	0
2,025	2,050	0	0	47	0
2,050	2,075	0	0	50	0
2,075	2,100	0	0	54	0
2,100	2,125	0	0	57	0
2,125	2,150	0	0	60	0
2,150	2,175	0	0	64	0
2,175	2,200	0	0	67	0
2,200	2,225	0	0	71	0
2,225	2,250	0	0	74	0
2,250	2,275	0	0	78	0
2,275	2,300	0	0	81	0
2,300	2,325	b2	0	85	b2
2,325	2,350	5	0	88	5
2,350	2,375	9	0	92	9
2,375	2,400	12	0	96	12
2,400	2,425	16	0	99	16
2,425	2,450	19	0	102	19
2,450	2,475	22	0	105	22
2,475	2,500	26	0	109	26
2,500	2,525	29	0	112	29
2,525	2,550	33	0	116	33
2,550	2,575	36	0	119	36
2,575	2,600	40	0	123	40
2,600	2,625	43	0	126	43
2,625	2,650	47	0	130	47
2,650	2,675	50	0	133	50
2,675	2,700	54	0	137	54
2,700	2,725	57	0	140	57
2,725	2,750	60	0	143	60
2,750	2,775	64	0	147	64
2,775	2,800	67	0	151	67
2,800	2,825	71	0	155	71
2,825	2,850	74	0	158	74
2,850	2,875	78	0	163	78
2,875	2,900	81	0	167	81
2,900	2,925	85	0	171	85
2,925	2,950	88	0	175	88
2,950	2,975	92	0	179	92
2,975	3,000	96	0	183	96
3,000					
3,000	3,050	100	0	189	100
3,050	3,100	107	0	197	107
3,100	3,150	114	0	204	114
3,150	3,200	121	0	212	121
3,200	3,250	128	0	220	128
3,250	3,300	135	0	228	135
3,300	3,350	142	0	236	142
3,350	3,400	149	0	244	149
3,400	3,450	156	93	252	156
3,450	3,500	164	10	260	162
3,500	3,550	172	17	268	169
3,550	3,600	180	24	276	176
3,600	3,650	188	31	283	183
3,650	3,700	196	38	291	190
3,700	3,750	203	45	299	197
3,750	3,800	211	52	307	204
3,800	3,850	219	59	316	211
3,850	3,900	227	66	324	218
3,900	3,950	235	73	333	225
3,950	4,000	243	79	342	232
4,000					
4,000	4,050	251	86	351	238
4,050	4,100	259	93	360	245
4,100	4,150	267	100	369	252
4,150	4,200	275	107	378	259
4,200	4,250	282	114	387	266
4,250	4,300	290	121	396	273
4,300	4,350	298	128	404	280
4,350	4,400	306	135	413	287
4,400	4,450	315	142	422	294
4,450	4,500	323	149	431	302
4,500	4,550	332	156	440	310
4,550	4,600	341	162	448	318
4,600	4,650	350	169	458	326
4,650	4,700	359	176	467	334
4,700	4,750	368	183	475	342
4,750	4,800	377	190	484	350
4,800	4,850	386	197	493	357
4,850	4,900	395	204	502	366
4,900	4,950	403	211	511	373
4,950	5,000	412	218	520	381
5,000					
5,000	5,050	421	225	529	389
5,050	5,100	430	232	538	397
5,100	5,150	439	238	547	405
5,150	5,200	448	245	556	413
5,200	5,250	457	252	564	421
5,250	5,300	466	259	573	429
5,300	5,350	474	266	582	436
5,350	5,400	483	273	591	444
5,400	5,450	492	280	600	452
5,450	5,500	501	287	609	460
5,500	5,550	510	294	618	468
5,550	5,600	519	302	627	476
5,600	5,650	528	310	635	484
5,650	5,700	537	318	644	492
5,700	5,750	546	326	653	500
5,750	5,800	554	334	662	508
5,800	5,850	563	342	671	515
5,850	5,900	572	350	680	523
5,900	5,950	581	357	689	531
5,950	6,000	590	365	698	539
6,000					
6,000	6,050	599	373	709	547
6,050	6,100	608	381	719	555
6,100	6,150	617	389	730	563
6,150	6,200	626	397	740	571
6,200	6,250	634	406	750	579
6,250	6,300	643	413	761	587
6,300	6,350	652	421	771	594
6,350	6,400	661	429	781	602
6,400	6,450	670	436	792	610
6,450	6,500	679	444	802	618
6,500	6,550	688	452	812	627
6,550	6,600	697	460	823	635
6,600	6,650	707	468	833	644
6,650	6,700	716	476	844	653
6,700	6,750	726	484	854	662
6,750	6,800	735	492	864	671
6,800	6,850	744	500	875	680
6,850	6,900	754	508	885	689
6,900	6,950	763	515	895	698
6,950	7,000	772	523	906	707
7,000					
7,000	7,050	782	531	916	716
7,050	7,100	791	539	927	724
7,100	7,150	801	547	937	733
7,150	7,200	810	555	947	742
7,200	7,250	819	563	958	751
7,250	7,300	829	571	968	760
7,300	7,350	838	579	978	769
7,350	7,400	848	587	989	778
7,400	7,450	857	594	999	787
7,450	7,500	866	602	1,009	796
7,500	7,550	876	610	1,020	804
7,550	7,600	885	618	1,030	813
7,600	7,650	894	627	1,041	822
7,650	7,700	904	635	1,051	831
7,700	7,750	913	644	1,061	840
7,750	7,800	923	653	1,072	849
7,800	7,850	932	662	1,082	858
7,850	7,900	941	671	1,092	867
7,900	7,950	951	680	1,103	875
7,950	8,000	960	689	1,113	884

*This column must also be used by a qualifying widow(er).

Continued on next page

a If your taxable income is exactly $1,700, your tax is zero.
b If your taxable income is exactly $2,300, your tax is zero.
a If your taxable income is exactly $3,400, your tax is zero.

The Harris Survey

For Release: Monday AM, September 21st, 1981

1981 #76
ISSN 0273-1037

MAJORITY OF AMERICANS REJECT PROPOSAL TO ABANDON GRADUATED INCOME TAX

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By Louis Harris

The recent proposals by some supply-side economists that the country ought to abandon the graduated income tax for a system under which everyone pays a 20 percent federal income tax meets with a resounding rejection by 61-34 percent of Americans.

The main argument by advocates for repeal of the graduated income tax is that "people with higher incomes are the ones who invest in the economy and make it grow, so they need a break like this to stimulate investment and growth." This is the same claim that was made during the debate on an across-the-board tax cut that was finally passed by Congress in July.

However, a 56-39 percent majority of Americans does not go along with this argument, according to the latest Harris Survey conducted between Aug. 11 and Aug. 16 among a cross section of 1,248 adults nationwide. If higher-income people are to be induced to invest more of their funds, most Americans would prefer that some means other than a change in the concept of the graduated income tax be devised. All groups below the $35,000 income level want to retain the progressive tax system under which the higher a person's income, the higher the percentage of federal income tax the individual will pay. The country has had that system for 68 years, ever since the Constitution was amended to permit the federal government to levy a federal income tax.

Among those with annual incomes of more than $35,000, however, a 49-47 percent plurality goes along with the argument that by going to a 20 percent across-the-board tax, investment will be stimulated. Supply-siders no doubt would argue that this is proof positive that such a change in the tax system would indeed set loose a new flood of investment money. However, the rest of the public clearly doesn't see it that way. Instead, they seem to be convinced that having those with the highest incomes pay the same tax rate as those with lower incomes is a windfall benefiting those who are most in a position to pay higher taxes.

In fact, a 53-39 percent majority feels that "to charge everyone the same percentage of their income in taxes would be decreasing federal income taxes for the rich and increasing taxes for people with incomes below $18,000 a year." Even those in the over-$35,000 income bracket agree, by 57-36 percent, that this would be the case.

This latest trial balloon on repealing the graduated income tax is one of a growing number of measures put forth by supply-side economic advocates. People now expect that one of the singular marks of the Reagan years in the White House will be harder times for the less privileged and a field day for the most privileged. When asked to estimate what things would be like a year from now, a 75-21 percent majority of Americans is convinced that "the rich and big business will be much better off" and a 64-32 percent majority feels "the elderly, the poor and the handicapped will be especially hard hit."

If a major effort is mounted to repeal the graduated income tax, it will mean undertaking the considerable task of reversing the opinion of a sizable majority of the American people. Not only does a 61-34 percent majority oppose a 20 percent across-the-board personal income tax, but also, by 58-38 percent, a majority feels that the current progressive income tax, based on the principle that "higher-income people not only have to pay more in taxes, but must pay a greater percentage of their income in taxes," is "fair and equitable."

At a time when taxes clearly are not popular, to have a 20-point majority that feels the federal income tax is fair and equitable is a real measure of the job facing those who would attempt to change the system. Significantly, a 60-37 percent majority of the college-educated defends the current tax principle, as does a 67-30 percent of professional people. However, among business executives, only a 51-46 percent majority shares this view, as does a 53-45 percent majority of those in the highest income brackets.

(over)

These latest results show that political conservatives have not yet reached the point where they are ready to change the graduated income tax. By 57-38 percent, a majority would oppose a 20 percent across-the-board federal income tax. And a 55-41 percent majority of conservatives feels the current federal tax system is "fair and equitable."

TABLES

Between August 11th and 16th, the Harris Survey asked a cross section of 1,248 adults nationwide by telephone:

"For the past 68 years, the federal income tax has been based on the principle that higher-income people not only have to pay more in taxes but must pay a greater percentage of their income in taxes. Do you feel that principle is fair and equitable or not?"

GRADUATED INCOME TAX FAIR?

	Fair and equitable %	Not fair and equitable %	Not sure %
Total	58	38	4
8th grade education	50	31	19
High school	57	39	4
College	60	37	3
$7,500 or less	59	36	5
$7,501-15,000	56	37	7
$15,001-25,000	63	34	3
$25,001-35,000	61	38	1
$35,001 and over	53	45	2
Professional	67	30	3
Executive	51	46	3
Proprietor	54	44	2
Skilled labor	60	39	1
White collar	56	41	3
Conservative	55	41	4
Middle of the road	62	35	3
Liberal	55	41	4

"Now it is being proposed that instead of the system of higher-income people paying a greater percentage in federal income taxes, everyone would pay the same percentage of their income in taxes, such as 20% for everyone. Would you favor having everyone pay the same percentage of their income in taxes, or would you favor keeping the present system, under which higher-income people pay a greater percentage in taxes?"

EVERYONE PAY SAME PERCENTAGE OF INCOME TAX?

	Favor everyone paying same percentage %	Favor keeping present system %	Not Sure %
Total	34	61	5
8th grade education	29	50	21
High school	32	64	4
College	38	57	5
$7,500 or less	19	70	11
$7,501-15,000	32	65	3
$15,001-25,000	35	61	4
$25,001-35,000	38	56	6
$35,001 and over	48	49	3

continued

EVERYONE PAY SAME PERCENTAGE OF INCOME TAX? (CONT'D)

	Favor everyone paying same percentage %	Favor keeping present system %	Not sure %
Professional	37	57	6
Executive	39	59	2
Proprietor	44	54	3
Skilled labor	38	59	3
White collar	31	62	7
Conservative	38	57	5
Middle of the road	35	61	4
Liberal	39	66	5

"Now let me read you some statements about changing the federal income tax system so that every person pays the same 20% of their income in taxes. For each, tell me if you agree or disagree."

STATEMENTS ON CHANGING FEDERAL INCOME TAX SYSTEM

	Agree %	Disagree %	Not sure %
To charge everyone the same percentage of their income in taxes would be decreasing federal income taxes for the rich and increasing taxes for people with incomes below $10,000 a year	53	39	8
People with higher incomes are the ones who invest in the economy and make it grow, so they need a break like this to stimulate investment and growth	39	56	5

METHODOLOGY

This Harris Survey was conducted by telephone with a representative nationwide cross section of adults 18 and over at 1,248 different sampling points within the United States between August 11th and 16th. Figures for age, sex and race were weighted where necessary to bring them into line with their actual proportions in the population.

In a sample of this size, one can say with 95% certainty that the results are within plus or minus 3 percentage points of what they would be if the entire adult population had been polled.

This statement conforms to the principles of disclosure of the National Council on Public Polls.

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220 East 42nd Street, New York, NY 10017

812110

TABLE 1. DISTRIBUTION OF TAX LIABILITIES UNDER ALTERNATIVE FLAT RATE TAX SYSTEMS COMPARED TO 1984 TAX LAW[a] AT 1981 INCOME LEVELS

Expanded Income (thousands)	Number of Taxable Returns (thousands)	Tax Liability 1984 Law (millions)	System 1 (11.8 percent tax on adjusted gross income with long-term capital gains included in full)			System 2 (19.5 percent tax on 1984 law taxable income less zero bracket amount)			System 3 (15.7 percent tax on 1984 law taxable income less zero bracket amount; with long-term capital gains included in full, and no itemized deductions)			System 4 (18.7 percent tax on taxable income as in System 3 with $1,500 personal exemption and $3,000 ($6,000) zero bracket amount for single (joint) returns)		
			Tax Liability (millions)	Change (Percent)	Change (Dollars Per Return)	Tax Liability (millions)	Change (Percent)	Per Return)	Tax Liability (millions)	Change (Percent)	Change (Dollars Per Return)	Tax Liability (millions)	Change (Percent)	Change (Dollars Per Return)
< 5	6,482	403	5,479	1,259.5	783.07	1,574	290.7	180.71	2,232	453.7	282.10	1,996	395.2	245.71
5- 10	15,057	5,772	14,280	147.4	565.04	8,752	51.6	197.91	7,854	36.1	136.26	5,345	-7.4	-28.33
10- 15	13,092	12,526	19,700	57.3	547.99	17,610	40.6	386.31	15,720	25.5	243.97	12,698	1.4	13.11
15- 20	10,737	17,462	22,496	28.8	468.88	22,665	30.0	484.54	20,778	19.0	308.88	18,802	7.7	124.76
20- 30	16,800	44,080	49,701	12.8	334.58	52,871	19.9	523.28	49,978	13.4	351.06	48,170	9.3	243.45
30- 50	13,568	63,833	60,579	-5.1	-239.82	66,419	4.1	190.61	66,466	4.1	194.68	68,804	7.8	366.41
50-100	3,550	38,087	27,389	-29.2	-3,155.74	30,486	-21.2	-2,290.90	32,658	-15.6	-1,684.20	36,104	-6.7	-721.69
100-200	631	18,636	9,872	-47.1	-13,920.58	10,743	-42.4	-12,540.20	12,459	-33.2	-9,821.59	14,344	-23.1	-6,833.56
200 <	174	16,385	7,675	-53.2	-53,107.15	7,129	-56.5	-56,438.05	10,050	-38.7	-38,630.67	11,843	-27.7	-27,692.33
Total	80,110	217,803	217,172	-0.3	-7.87	218,249	0.2	5.57	218,194	0.2	4.88	218,106	0.1	3.78

SOURCE: Joint Committee on Taxation.

a. To facilitate comparison, 1984 law does not include the earned income credit, the two-earner couple deduction, or the IRA or Keogh provisions. The flat rate tax systems similarly do not include those provisions.

b. Outcomes under the flat-rate tax for tax returns of under $5,000 of income would be highly uncertain. Some taxpayers at that income level currently make use of tax preferences that would be terminated under the flat-rate tax, and those taxpayers would thus face substantial tax increases. A particular problem would arise under System 1, in which all income would be subject to tax without exemption or deduction; many households with very low incomes who are excused from filing tax returns under the 1984 law are therefore not represented in the table, but would have to file returns and pay taxes under System 1. The impact of this factor on the table would likely be small, though it would significantly change administrative burdens under the tax system.

THE HALL-RABUSHKA PROPOSAL

SUPPLEMENT TO

TESTIMONY OF

Joseph J. Minarik*
Deputy Assistant Director
Tax Analysis Division
Congressional Budget Ofice

Before the

Subcommittee on Monetary and Fiscal Policy
Joint Economic Committee

July 27, 1982

* I would like to acknowledge Valerie Amerkhail and Janice Peskin for helpful discussions. Robert E. Hall kindly read a draft to check for factual errors regarding his proposal. Any remaining errors are my own.

SUMMARY

Robert E. Hall and Alvin Rabushka have proposed an interesting variation on the flat rate tax theme. Their approach retains most of the advantages and disadvantages of the flat rate tax on individual income (described in the main body of my statement), but it adds a new twist through coordination with a flat rate tax on corporate income.

The major structural innovation of the Hall-Rabushka proposal is elimination of the double taxation of corporate dividends. For years, tax theorists have struggled to devise schemes to eliminate double taxation, generally beginning by making dividends tax deductible to the corporation and then taxing them according to the individual recipient's ability to pay. Armed with the flat tax rate for both individuals and corporations, Hall and Rabushka reason that it does not matter where the dividends are taxed, and so they reverse the usual process -- making dividends taxable to the corporation but nontaxable to the individual.

This novel approach brings with it some good news and some bad news. The good news is that the tax system is much simpler, because the revenue authorities need not follow the dividends from payer to recipient to assure compliance at the individual level. The bad news is that a low-income shareowner, such as a retiree, will receive dividends that have already borne tax; if the dividends came to him without prior taxation -- as would happen in the conventional and more complicated single-tax system -- he could use his personal exemption and standard deduction to avoid paying tax. Therefore, the Hall-Rabushka approach to ending double taxation is

a tradeoff: it is simpler than the conventional alternatives, but it does not tax dividends according to the recipient's ability to pay. In any event, this approach is probably the most significant simplification made possible by the flat rate tax, and Hall and Rabushka should be congratulated for picking up on it.

With the end to double taxation of dividends plus elimination of taxation of capital gains and the low flat rate on individual and corporate income, the Hall-Rabushka proposal would clearly reduce the tax burden on capital by a substantial amount. Because they would also maintain the yield of the tax law that was in effect in 1981, it follows that they would raise the tax burden on labor by an equally substantial amount. Distributional estimates show that the tax liabilities of typical middle-income single persons and families would rise. A single person with a $15,000 income would pay 14 percent more under Hall-Rabushka than under 1984 law (i.e., the current tax law with the rates that it prescribes for 1984); four-person families with incomes of $25,000, $35,000, and $45,000 and typical itemized deductions would pay 43 percent, 22 percent, and 11 percent more, respectively. (Compared to the 1981 tax law, whose yield Hall and Rabushka would replicate, the $25,000 taxpayer would pay about 20 percent more, the $35,000 taxpayer would pay about the same, and the $45,000 taxpayer would get about a 12 percent tax cut.) In contrast, taxpayers with very high incomes would enjoy substantial tax cuts. On average, those with adjusted gross incomes (AGI) between $100,000 and $200,000 would receive tax cuts of about 45 percent; those with incomes over $1,000,000 would have their taxes cut by about 85 percent. When these tax liabilities are increased to account for Hall-Rabushka's different treatment of dividend and interest income (an adjustment that may or may

not be considered valid by any particular analyst), the tax cuts are still quite large, at 35 percent for the $100,000 - $200,000 group, and over 70 percent for those with AGI over $1,000,000. In comparison to the 1981 law, these tax cuts would be even larger.

The Hall-Rabushka proposal retains many of the efficiency characteristics of all flat rate taxes (as described in the main body of my statement). In several other respects, however, Hall-Rabushka is quite different. As I noted earlier, it would substantially shift the tax burden from capital to labor. One aspect of this shift is Hall-Rabushka's requirement that employers pay the 19 percent business tax on all forms of non-wage compensation: the Social Security and unemployment taxes; workers' compensation costs; and contributions to pension funds, and to life and health insurance programs. For higher wage employees, these costs would be shifted backward in some way from the employer to the employee. For lower-wage workers, the tax on unshiftable costs -- Social Security, unemployment taxes, and workers' compensation -- would increase employers' costs in the same manner as an increase in the minimum wage. Some of these workers thus might find themselves priced completely out of the job market.

Other features of the Hall-Rabushka proposal would have sharp impacts on particular sectors of the economy. Eliminating the tax deductibility of interest would be particularly damaging to some businesses that borrow to carry inventory, though Hall and Rabushka provide a countervailing benefit through the expensing of inventory. Prohibiting the deduction of any unused depreciation allowances after the proposal takes effect would have a capricious and negative impact on any firms that happened recently to have made any long-lived investments; as the effective date of

the proposal approached, it would also create a strong incentive to postpone investment. (A combination of the tax on non-wage compensation, the repeal of the deductibility of interest, and the elimination of unused depreciation allowances would fall firmly on such industries as the wholesale and retail trade, which are labor intensive, borrow to carry inventory, and use long-lived capital.) Firms that are now struggling would be particularly hard hit by eliminating the use of pre-existing net operating loss carryforwards and unused investment credits.

A final general area to examine is Hall-Rabushka's estimate of the revenue yield of their proposal. Because the attractiveness of the proposal is in part a function of the low tax rate (19 percent), it is important that the system yield the revenues claimed at that rate.

Estimating tax revenue from the National Income and Product Accounts (NIPAs) is difficult and perilous, and I believe that Hall and Rabushka fell into some traps. They include in their tax base all non-wage compensation paid in the economy; they apparently neglect to consider that some of that non-wage compensation is paid by nontaxable entities -- governments and not-for-profit institutions. Since the date of the hearing, Hall and Rabushka have added to their proposal a separate 19 percent tax on nonwage compensation paid by governments and not-for-profits. This is definitely an additional layer of complexity, and though I am not a lawyer, I do wonder about constitutional issues. Also, where Hall and Rabushka propose to tax foreign-owned firms located in the United States and not to tax U.S.-owned firms overseas, they estimate their revenues as if they were doing just the reverse. (That is, they include in their tax base the rest-of-the-world component of gross national

product, which is U.S. income from overseas minus the income of foreign-owned firms in the United States.) Each of these two inconsistencies would reduce the Hall-Rabushka tax base by about $50 billion at 1981 levels of income. The combined effect would be to require that their tax rate be increased from 19 to 20 percent. Hall and Rabushka have claimed that they would restore $50 billion to the tax base by eliminating the deductibility of indirect business taxes. This would cause businesses to pay tax on what is now considered a legitimate business expense.

In another area, Hall and Rabushka leave in their tax base some income items that have always been assumed to be very difficult, if not impossible, to tax. These include business writeoffs of bad consumer debts and liability for injuries; the free services provided to consumers by banks and other financial intermediaries; food and fuel produced and consumed on farms; and free meals, clothing, and lodging provided to employees. If these incomes were judged administratively infeasible to tax, the tax base would be reduced by about another $50 billion, and the tax rates would have to be increased by another one-half point.

The Hall-Rabushka tax base estimate may also be optimistic because of its assumptions regarding the underground economy. Hall and Rabushka implicitly assume that all income included in the NIPAs would be reported for tax purposes. However, current income tax reporting runs billions of dollars short of NIPA estimates. Therefore, if much of the underground economy is not brought to the surface by the Hall-Rabushka plan -- and as I noted earlier, Hall and Rabushka would ask taxpayers at middle-income levels to pay more than they would under current law -- less revenue would be collected than Hall and Rabushka predict.

Finally, without the Hall-Rabushka transition devices -- the cutoff of back depreciation allowances, net operating losses, and investment tax credits -- the revenue yield would be less than predicted.

In sum, Hall and Rabushka have devised a clever means of simplifying the individual and corporate income taxes while eliminating the double taxation of dividends through the flat rate tax. This simplification has the side effect of increasing the tax burden on middle-income taxpayers and reducing it on upper-income taxpayers; so in some sense, the simplification and the redistribution of the tax burden constitute a tradeoff. The proposal would increase the tax burden on labor and the cost of labor while reducing the tax burden on capital. It could have sharply different effects on different sectors within the economy, and could bear heavily on firms that now are only marginally profitable or worse. The revenue estimates for the proposal appear to be optimistic for a number of reasons, and it is possible that the planned tax rate would have to be raised.

INTRODUCTION

Robert E. Hall and Alvin Rabushka have proposed an interesting variation on the flat rate tax theme that would retain most of the advantages and disadvantages of the flat rate income tax on individual income but would add a new twist through coordination with a flat rate tax on corporate income.

Inasmuch as the Subcommittee has chosen to concentrate in this hearing on the Hall-Rabushka proposal rather than on flat rate taxation in general, I have prepared this supplemetary statement to contribute more directly to the deliberations. It

should be understood that this statement responds only to the Hall and Rabushka paper, "A Simple Income Tax with Low Marginal Rates," (Hoover Institution, Stanford University, January 1982, revised July 1982; henceforth referred to by page number only). It does not apply to any piece of legislation that has been submitted to the Congress.

Finally, it must be understood that this statement will be rather technical. Because the Hall and Rabushka proposal adds many details to the general concept of the flat rate tax, any analysis of the proposal must be detailed.

STRUCTURE OF THE PROPOSAL

The Hall-Rabushka proposal can be logically divided into four parts. It would:

- Institute a single 19 percent rate of tax on individual and corporate income;
- Repeal the taxation of corporate dividends at the individual level;
- Make interest taxable to the payer but tax-free to the recipient (the reverse of the current practice); and
- Repeal the taxation of capital gains.

This package includes features additional to the general flat rate individual income tax discussed in my original statement, specifically, the taxation of corporations in the first point, and the second, third, and fourth points in their entirety.

The major distinction between the Hall-Rabushka proposal and the conceptually narrower flat tax proposals is the treatment of corporate and individual income. There are two basic theories of corporate taxation. One, the "separate entity"

theory, is the basis for our current tax system; it holds that corporations, because of their special legal status and privileges, are independent entities that should be taxed in and of themselves. Thus, corporate income should be taxed once at the corporate level, and a second time when it is distributed to the shareholders. The second theory, the "conduit" approach, maintains that corporations are merely groups of individuals cooperating for business purposes; therefore, the owners of the corporations should be taxed individually according to their ability to pay, but the corporate shell should not be taxed. So under the conduit theory, corporate income should be taxed only once.

Hall and Rabushka subscribe to this second theory, and so they eliminate the double taxation of dividends. However, they turn the conduit theory around 180 degrees and tax the corporate income at the corporate level, not at the individual level. This reverse approach has simplicity advantages, because the revenue authorities do not have to track down payments of dividends from payer to recipient in order to assure compliance at the individual level. (The same advantage accrues from shifting the taxation of interest from the individual recipient to the business payer.) This change is probably the most significant simplification possible through the institution of a flat rate tax, and Hall and Rabushka should be congratulated for recognizing it.

This reverse conduit approach does have a curious implication, however: corporate income is taxed according to the ability to pay of the corporation, not the individual. Thus, the conduit theory would require that corporate income distributed to a low-income shareholder not be taxed, but that dividends paid by a currently

unprofitable corporation be taxed if they are received by higher-income individuals. The Hall-Rabushka approach yields the opposite result: the dividends of a currently profitable corporation are taxed, and those of a currently unprofitable corporation are not taxed, no matter who receives them. Thus, the guiding principle of Hall-Rabushka is not the conduit theory's "corporations don't pay taxes, only people pay taxes," but rather (at least as far as corporate income is concerned) "only corporations pay taxes."

The practical importance of this theoretical irregularity is significantly reduced by the taxation of both corporations and individuals at the same flat rate; however, the effect is not eliminated. There are some low-income retirees who live on receipts of dividends (along with interest, which Hall-Rabushka would treat analogously to dividends, and Social Security, which is now and would remain tax free). With integration of the corporate and individual income taxes according to the conduit theory, a low-income recipient of dividends would receive a refund of the corporate tax on those dividends. Under Hall-Rabushka, there would be no such refund; the tax on corporate income thus would not be a real withholding tax, because no refund would be made.

The cost to low-income taxpayers of omitting refunds, relative to true integration, can easily be measured; taxpayers with only dividend income should receive refunds of 19 percent of their dividends up to the amount of their personal allowances. Thus, the worst case (at 1982 allowance levels) would be a couple living on $6,200 of dividends; they would receive a refund of $1,178 under a fully integrated 19 percent tax rate system, but no refund under Hall-Rabuska. (The same

phenomenon would occur, but in a different way, in the case of interest income. Suppose the couple received $6,200 of interest from short-term securities instead of dividends and therefore owed no taxes. If the taxability of their interest income and the deductibility of the payer's interest expense were removed as Hall and Rabushka propose, then in all likelihood pre-tax interest rates would fall. The couple would therefore suffer a reduction in their interest receipts but would enjoy no compensating reduction in taxes.) A refund could be introduced into the Hall-Rabushka system, but that would bring back the complication of tracing dividend payments to their recipients. Therefore, for people who believe in the conduit theory, Hall-Rabushka is a tradeoff--it is simpler because tax payments are made only by corporations, but it fails to relieve low-income individuals from taxation of their corporate-source income.

The elimination of the double taxation of dividends is justified by the alternative theory of corporate taxation to which Hall and Rabushka subscribe. Despite the theoretical backing, however, this change still would substantially reduce the tax burden on capital, and it would lose the revenue that would have been collected if dividends were taxed at the individual level. When the elimination of taxation of capital gains and the flattening of the tax rate schedule are added to the system, the result is an even more substantial reduction in the taxation of capital. Hall and Rabushka clearly intended this change. Because tax revenues would be held constant under their proposal, however, the inevitable result is an equally substantial increase in the tax burden on labor; and the receipt of labor income is heavily concentrated in middle-income households. This suggests that there would be

significant shifts in the distribution of the tax burden under the Hall-Rabushka proposal; I will discuss these factors in the next section.

DISTRIBUTIONAL EFFECTS

The main body of my statement shows that any flat rate individual income tax would inevitably redistribute the tax burden from upper- to middle-income taxpayers. The Hall-Rabushka proposal is no exception.

I have not been able to obtain detailed distributional tabulations for the Hall-Rabushka proposal like those in my main statement. Instead, I have prepared comparisons of tax liabilities of typical middle-income taxpayers under Hall-Rabushka and 1984 law (i.e., the current tax law with the rates that it prescribes for 1984), and I have computed aggregate tax liabilities for upper-income groups from historical data.

Table A shows the tax liabilities of typical middle-income one-earner families with four members. The table shows that families who claim the standard deduction, and who therefore would lose no itemized deductions, would nonetheless pay higher taxes up to almost $35,000 of income. A family with an income of $15,000 would pay $285 (about 30 percent) more than under current law. At $25,000, the tax increase would be $471, or about 18 percent. Above $35,000, families not itemizing would receive tax cuts under Hall-Rabushka; however, more than 82 percent of taxpayers at those income levels now do itemize. For families who itemize an average percentage of their total incomes, Hall-Rabushka would increase taxes over the entire middle-

income range. At $25,000 of income, the tax increase would be $953, or about 43 percent; at $35,000, the tax increase is $923, or about 22 percent.

Single taxpayers tend to have lower incomes and to claim the standard deduction. Table B shows that typical single taxpayers would pay more under the Hall-Rabushka proposal over a range of $10,000 to $20,000. At $15,000, the tax increase would be $251, or about 14 percent.

In contrast, Tables C through F show the tax liabilities for taxpayers with adjusted gross incomes of over $100,000 on 1979 tax returns, under Hall-Rabushka and 1984 law. These tables show that, for these taxpayers, the Hall-Rabushka proposal would cut taxes by relatively substantial amounts. The tax cut for those with $100,000 - $200,000 of income would be about 47 percent; from $200,000 - $500,000 of income, 63 percent; from $500,000 - $1,000,000 of income, 75 percent; and for those with over $1,000,000, 86 percent.

Hall and Rabushka make the point in their paper (page 39) that, in effect, taxes have been prepaid for receipts of interest and dividends, because both are taxed to the payer. (This point probably has more validity for interest than for dividends. Taxability of interest is transferred from the recipient to the payer by Hall-Rabushka. On the other hand, under current law, dividends are taxable to both the payer and the recipient, so the repeal of individual income taxation of dividends would really be just a tax cut, in keeping with Hall-Rabushka's approach to the conduit theory.) To show the effect of this argument, Tables C through F also show the tax liability as if the 19 percent tax rate were paid on interest and dividends, From Hall and Rabushka's point of view, the tax cut relative to 1984 law would be 35

percent at the $100,000 to $200,000 level; 48 percent from $200,000 to $500,000; 59 percent from $500,000 to $1,000,000; and 72 percent for taxpayers with incomes of $1,000,000 and over.

Hall Rabushka designed their plan to yield the same revenues as would the law that was in effect in 1980, so a comparison to that law's burdens is also relevant. The 1980 law would impose taxes about 30 percent higher than the 1984 law, so middle-income tax increases under Hall-Rabushka would appear smaller by that comparison. Upper-income tax cuts, in contrast, would be even larger.

A comparison of Tables C through F with Table A in the main body of my testimony is impossible for a number of technical reasons. One can, though, compute from Table A the tax liabilities under System 1 (the 11.8 percent tax on gross income) to give some sense of the relative tax liabilities of Hall-Rabushka and the other flat tax systems discussed earlier. Tables C through F show that tax liabilities under Hall-Rabushka would be slightly higher than the tax on gross income for the $100,000-$200,000 group, but above that level they would be lower. If 19 percent of interest and dividends is included with taxes, Hall-Rabushka taxes would be higher than the 11.8 percent tax on gross income up to $500,000 of adjusted gross income (AGI) and lower above that level; for tax returns of more than $1,000,000 of AGI, Hall-Rabushka taxes would be lower by 45 percent than the 11.8 percent tax on gross income.

A relatively minor distributional point relates to the treatment of business losses. Hall and Rabushka would prohibit the offsetting of self-employment business losses against wage and salary income under the compensation tax to maintain

consistency in the treatment of business income between sole proprietorships and corporations. In two-earner families, a self-employed person could suffer a legitimate business loss but be unable to obtain tax relief by netting that loss against the compensation income of his or her spouse.

Other features of the Hall-Rabushka proposal would affect the distribution of income and of the tax burden. In particular, the economic effects of Hall-Rabushka's treatment of non-wage compensation would likely make the tax burden on labor heavier than is suggested in Tables 1 and 2.

ECONOMIC EFFECTS

As I stated earlier, the Hall-Rabushka proposal has many of the general characteristics of other flat rate tax systems, and so the comments on economic efficiency in the main body of my statement would still apply in this context. Some of the details of Hall-Rabushka are quite unusual, however, and require specific analysis.

As I noted earlier, the Hall-Rabushka proposal would significantly reduce the tax burden on capital and increase the tax burden on labor. Part of this effect is illustrated in Tables A and B, showing the tax increase on middle-income taxpayers with labor incomes. But another part shows up in the business tax. Hall and Rabushka propose to make taxable to employers the non-wage compensation they pay to employees; this includes employer contributions for Social Security, life, health, and unemployment insurance, pensions, and workers' compensation. This feature would significantly increase the cost of labor to the employer, thereby

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discouraging hiring. For higher-wage workers, employers would likely negotiate for lower money wages or for turning fringe benefits and their costs back to the workers, who would have to buy them out of after-tax income, making the workers worse off. And some lower-wage workers might find themselves priced completely out of the market. For their employers, adding an income tax on the existing Social Security and unemployment taxes, workers' compensation costs, and any other state-mandated fringe benefits, would be tantamount to increasing the minimum wage.

A second prominent feature of the Hall-Rabushka proposal is eliminating the tax deductibility of interest. On the plus side, this proposal would permit a simplification of the tax system (described earlier) and eliminate a distorting interaction among inflation, interest rates, and the tax system. Unfortunately, though, it would introduce new distortions of its own. Eliminating the deductibility of interest makes perfect sense when borrowing is undertaken for investment that is immediately expensed for tax purposes, as would be under Hall-Rabushka. Borrowing is also undertaken for carrying inventory, however, and in certain industries can be a significant cost of doing business. To deny the deduction in those industries could significantly increase taxes. Because of the fungibility of money, it is probably impossible to repeal the deductibility of interest for some purposes but not for others Therefore, the dislocations caused by repealing deductibility would simply have to be weighed in the balance against the other effects or repeal. Hall-Rabushka would allow expensing of inventory, which would provide tax relief in some circumstances; but when firms borrow to hold inventory on a short inventory cycle, eliminating interest deductibility would have a bigger, negative effect.

A third feature of the Hall-Rabushka plan is disallowing all deductions for undepreciated past investment upon the effective date of their proposal. Hall and Rabushka argue that the deductions would be less important because of the new, lower tax rate, and that the current accelerated depreciation and investment tax credit mean that most of the tax benefits of past investment have already been realized. The treatment of unused depreciation allowances could conceivably be far more important than Hall and Rabushka suggest, however. First of all, undepreciated capital in the economy totals hundreds of billions of dollars. Even at a flat 19 percent tax rate, the financial effect of prohibiting deductibility of back depreciation would be enormous. And second, a simple prohibition would be quite capricious in its effect from firm to firm. A firm with recent investment largely in short-lived equipment would have cashed in its investment credits and much of its depreciation allowances; it might be happy to trade in its remaining depreciation allowances for a lower tax rate. On the other hand, another firm that had recently invested in plant (which receives no up-front investment credit) or long-lived equipment might take heavy losses in the transition.

Another aspect of cutting off back depreciation relates to the transition to the new system. Because itemized deductions are to be repealed under the individual income tax, it might be suggested to adopt the Hall-Rabushka proposal prospectively by several years before putting it into effect to allow housing and other markets time to adjust. If it then became clear, however, that all unused depreciation allowances would become worthless in several years, there would be a tremendous incentive for postponement of investment in long-lived capital. As the transition date approached,

the postponement incentive would embrace shorter-lived equipment. The disruption of capital markets would be considerable. As a result, a complicated transition mechanism would be necessary.

Each of these three features of the Hall-Rabushka proposal -- taxation of the employer for non-wage compensation, elimination of the deductibility of interest, and prohibition of the deduction of unused depreciation -- could have important economic effects on its own. In certain sectors of the economy, these effects could compound each other. For example, the wholesale and retail industries are comparatively labor intensive, use long-lived capital, and borrow to carry inventory. The firms in these industries (except those that happen to need to build new plant) would gain little from the introduction of expensing of investment, but they would lose heavily from the nondeductibility of unused depreciation on their existing plant, and from the nondeductibility of their inventory borrowing (plus any borrowing for existing plant). Finally, they would face new income tax liabilities on their substantial costs for non-wage compensation. Though these industries might be the ones hardest hit, any individual firm with a heavy concentration of undepreciated capital or debt could be disadvantaged by a changeover to the Hall-Rabushka proposal.

There are other features of the Hall-Rabushka proposal that could cause considerable dislocation for existing firms. Hall and Rabushka's estimate of the revenue yield under their business tax (p.26) makes no allowance for the deductibility of net losses (NOLs) accumulated before the effective date of their proposal. Presumably, this means that they intend also to cut off deductibility of past NOLs, in keeping with their handling of depreciation. This would have enormous tax

consequences for particular firms (such as Chrysler), that have been down on their luck; should such firms manage to turn the corner after Hall-Rabushka took effect, they will have to pay tax on their first dollar of net income. Thus, on a long-term basis, they will be paying tax on more than their net income.

A similar omission in the Hall-Rabushka revenue estimate is an allowance for unused investment tax credits (ITCs). One cannot know for sure, but every indication is that existing firms hold in excess of $10 billion of ITCs that they cannot now use because they have insufficient tax liability. If Hall and Rabushka were to devalue these unused ITCs to zero, they would be reducing the after-tax profits of these currently struggling firms, if and when they manage to turn around, by more than $10 billion. Again, as with the cutoff of deductibility of NOLs, this effect is concentrated a small group of firms.

REVENUE ESTIMATES

As I noted in the main body of my testimony, the attractiveness of a flat rate tax system is largely determined by what tax rate is feasible. Therefore, the estimate of the size of the tax base is critical. Hall and Rabushka give themselves a very difficult and perilous task when they attempt to measure the size of their tax base from the National Income and Product Accounts (NIPAs). The greatest difficulty is that the NIPAs include many items of income that could not likely be captured in the income tax.

One possible problem arises when Hall and Rabushka propose to tax all non-wage compensation under the business tax. In their revenue estimate (p.24), Hall and

Rabushka include the entire national income item for supplements to wages and salaries ($273.6 billion in the latest revision of the 1981 NIPAs) in their business income tax base. Elsewhere in their paper, Hall and Rabushka say that they would not tax the activities of federal, state, and local governments, and presumably they would also exempt not-for-profit institutions. The NIPA number for wage supplements, however, includes contributions by governments and not-for-profit institutions; without taxing governments and not-for-profit entities, collecting the tax on those wage supplements would be impossible. The implications of this for the tax base are significant. Government wages and salaries are about 19 percent of total wages and salaries. If government plus not-for-profit wage supplements come to the same fraction of that total, the overstatement of the Hall-Rabushka tax base is almost $52 billion.

A further economic problem arising from this quirk in the tax base relates to the allocation of labor. If private businesses have to pay a 19 percent tax on nonwage compensation but not-for-profit institutions and governments do not, the cost of labor would be lower for the public than the private sector of the economy. Thus, labor would tend to be reallocated from the private to the public sector.

To solve these problems, Hall and Rabushka have since decided to impose a separate 19 percent tax on nonwage compensation paid by governments and not-for-profits. This would solve the tax base problem, but it may raise a constitutional issue regarding the power of the federal government to tax state and local governments.

A second possible discrepancy in the Hall-Rabushka tax base relates to the foreign sector. In their paper (pp. 16-17), Hall and Rabushka propose to tax foreign-

owned businesses located in the United States in the same manner as U.S.-owned businesses, and not to tax the foreign operations of U.S. firms at all. In their revenue estimate, though, they do just the opposite. They include the "rest-of-the-world" sector of the Gross National Product (GNP) account in their tax base. The rest-of-the-world sector is the excess of the earnings of U.S. firms abroad over those of foreign-owned firms in the United States. Making the Hall-Rabushka tax base consistent with their tax principle for treating the foreign sector would require deducting the rest-of-the-world sector from GNP as the starting point of their tax base. (In other words, they would start with Gross Domestic Product instead of Gross National Product.) This would diminish the tax base by more than $49 billion. Together with a correction to the non-wage compensation segment of the Hall-Rabushka tax base, the total reduction in income subject to tax would be $101 billion. This means that, under Hall-Rabushka, the government would have to charge a 20 percent tax rate to collect the revenue they project at a 19 percent rate. This has obvious implications for the tax increases on middle-income taxpayers shown in Tables A and B .

Taxing the foreign sector in the fashion Hall and Rabushka suggest would require the renegotiation of numerous tax treaties, which could in some cases be very difficult. On the other hand, under Hall-Rabushka the United States could continue to tax foreign subsidiaries of U.S. firms as we do. In that case, though, they would have to make allowances for a foreign tax credit in their revenue estimates.

Hall and Rabushka have since claimed that they have understated their tax base by about $50 billion, because they would plan no business deduction for indirect

business taxes. I cannot comment on the implications for the tax base, but indirect business taxes are now considered a legitimate business expense, and eliminating their deductibility would surely have an uneven impact across sectors of the economy.

Another area that might be examined is the taxation of business transfers and imputations. Hall and Rabushka implicitly include in their business income tax base an item called "business transfers." Part of this item is business charitable contributions, and so Hall and Rabushka could tax that part; but the remainder is bad debt losses and liability payments for injury to individuals, both of which would appear to be legitimate business expenses. Another NIPA item partly in the business income tax base and partly in the compensation tax base is a set of imputations. These include such noncash forms of income as free meals to restaurant employees, free sevices provided by banks and other financial intermediaries, food and fuel produced and consumed on farms, and free clothing and lodging provided to employees. Such forms of noncash income are difficult to attach a dollar value to and would be even more difficult to tax. Together with business transfers, their combined value in 1981 probably came to about $50 billion (based on 1979 data, the latest detailed figures available). If these items were administratively judged infeasible to tax, they would have to be dropped from the Hall-Rabushka tax base, at the cost of another one-half percentage point on their tax rate.

Further possibly questionable areas also emerge in the Hall-Rabushka tax base. The most important one relates to the so-called underground economy. One hears much talk of a $103.5 billion dollar "tax reporting gap" in 1978 attributed to

incomplete reporting of income to the Internal Revenue Service (IRS). That estimate was made by comparing reported income with all of the legally taxable income in the NIPAs. Because Hall and Rabushka use the NIPAs to define their tax base, however, they are implicitly assuming that the full $103.5 billion tax reporting gap would be made up under their plan. If the underground economy did not surface entirely, revenue would still fall short.

An example: In 1979, the NIPAs showed $132 billion of income of unincorporated businesses. Tax returns of unincorporated businesses, in contrast, included only about $73 billion. Conceptual differences between those numbers that make a precise comparison impossible, but it is clear on an order-of-magnitude basis that tax reporting must improve substantially for the Hall-Rabushka revenue estimate to materialize. Though Hall and Rabushka point out that their 19 percent marginal tax rate might lure some tax evaders back to honesty, it is also true (as is shown in Tables A and B) that Hall and Rabushka would be asking middle-income tax evaders to pay more tax under their proposal than would be due under 1984 law. Hall and Rabushka also claim that they solve much of the underground economy problem by making dividend and interest income nontaxable to the individual; but dividend and interest income underreporting accounted for less than 12 percent of all revenue lost due to individual income underreporting in 1981 according to the Internal Revenue Service.

Another example of underground income in the Hall-Rabushka tax base is gratuities. The 1977 NIPAs include an estimate of $6.4 billion of income from tips. Tip reporting to the IRS was only about 14 percent of the NIPA estimate, however.

The Senate Finance Committee recently drafted an elaborate information reporting requirement that was designed to improve tip income reporting to only about 50 percent, but the plan was rejected on the Senate floor as too complicated and too costly. Hall and Rabushka, however, implicitly assume 100 percent reporting of NIPA tip income.

A final uncertainty regarding the Hall-Rabushka tax base involves their transition decisions discussed above in the context of economic effects: the prohibition of deductibility of unused depreciation allowances, net operating losses, and investment tax credits. These steps might appear as capricious confiscation, and thus they would likely prove highly controversial. If these transition decisions were reversed, the Hall-Rabushka tax base would be significantly smaller, and revenues would be lower in the initial years.

CONCLUSION

Hall and Rabushka have developed an interesting method of using the flat rate tax concept to simplify business and individual taxation. This simplification approach has the side effect of increasing the tax burden on middle-income taxpayers, and reducing it on upper-income taxpayers, so in some sense, the simplification and the redistribution of the tax burden constitute a tradeoff.

The Hall-Rabushka proposal would increase the tax burden on and the cost of labor. When it became effective, it would also cut off unused depreciation deductions, imposing an uneven loss of legitimate tax deductions across all investing firms in the economy, and encouraging a postponement of investment as the effective

date approached. It would prohibit the use of past net operating loss deductions and investment tax cedits, imposing a burden on firms that are currently unprofitable or marginally profitable.

Finally, the tax base of the proposal appears to be overestimated because of inconsistencies between the principles of the proposal and its interpretation of the National Income and Product Accounts, though this area is highly complex and doubtless requires further examination. The plan also assumes total compliance from the present underground economy. The combined effect of these factors seems likely to require a tax rate somewhat higher than stated to yield the revenue claimed.

TABLE A. TAX LIABILITIES FOR A FAMILY OF FOUR UNDER HALL-RABUSHKA AND 1984 LAW (In dollars)

	1984 Law (Standard Deduction)	1984 Law Itemized Deductions)	Hall-Rabushka
Wages, Salaries, or Self-Employment	15,000	N/A	15,000
Allowances	4,000[a]	N/A	8,450[b]
Net Taxable Income	11,000		6,550
Tax Liability	959[c]		1,244
Wages, Salaries, or Self-Employment	20,000	20,000	20,000
Allowances	4,000[a]	4,000[a]	8,450[b]
Excess Itemized Deductions	N/A	1,540	N/A
Net Taxable Income	16,000	14,460	11,550
Tax Liability	1,741[c]	1,495[c]	2,194
Wages, Salaries, or Self-Employment	25,000	25,000	25,000
Allowances	4,000[a]	4,000[a]	8,450[b]
Excess itemized Deductions	N/A	2,500	N/A
Net Taxable Income	21,000	18,500	16,550
Tax Liability	2,673[c]	2,191[c]	3,144
Wages, Salaries, or Self-Employment	30,000	30,000	30,000
Allowances	4,000[a]	4,000[a]	8,450[b]
Excess Itemized Deductions	N/A	3,050	N/A
Taxable Income	26,000	22,950	21,550
Net Tax Liability	3,815[c]	3,102[c]	4,094
Wages, Salaries, or Self-Employment	35,000	35,000	35,000
Allowances	4,000[a]	4,000[a]	8,450[b]
Excess Itemized Deductions	N/A	3,775	N/A
Net Taxable Income	31,000	27,225	26,550
Tax Liability	5,098[c]	4,121[c]	5,044

(Continued)

TABLE A. (Continued)

	1984 Law (Standard Deduction)	1984 Law Itemized Deductions)	Hall-Rabushka
Wages, Salaries, or Self-Employment	40,000	40,000	40,000
Allowances	4,000[a]	4,000[a]	8,450[b]
Excess Itemized Deductions	N/A	4,800	N/A
Net Taxable Income	36,000	31,200	31,500
Tax Liability	6,538[c]	5,154[c]	5,994
Wages, Salaries, or Self-Employment	45,000	45,000	45,000
Allowances	4,000[a]	4,000[a]	8,450[b]
Excess Itemized Deductions	N/A	5,825	N/A
Net Taxable Income	41,000	35,175	36,550
Tax Liability	8,188[c]	6,267[c]	6,944
Wages, Salaries, or Self-Employment	50,000	50,000	50,000
Allowances	4,000[a]	4,000[a]	8,450[b]
Excess Itemized Deductions	N/A	6,850	N/A
Net Taxable Income	46,000	39,150	41,550
Liability	9,848[c]	7,578[c]	7,894

SOURCE: Congressional Budget Office.

NOTES: All income assumed to be wages, salaries, or self-employment income earned by one spouse. N/A = not applicable. Data on itemized deductions for 1979 (latest available year):

Adjusted Gross Income Class	Percentage of Taxpayers Itemizing	Itemized Deductions as a Percentage of Adjusted Gross Income
20,000 - 25,000	52.0	24.7
25,000 - 30,000	67.1	22.5
30,000 - 50,000	82.4	20.5

a. Personal exemptions only.

b. Personal allowances assumed for Hall-Rabushka at 1984 income levels: $6,800 for married couples, $4,200 for single persons, $825 for dependents.

c. Tax liability according to 1980 law would be higher by approximately 30 percent of amount shown.

TABLE B. TAX LIABILITIES FOR SINGLE TAXPAYERS UNDER HALL-RABUSHKA AND 1984 LAW (In dollars)

	1984 Law	Hall-Rabushka
Wages, Salaries, or Self-Employment	10,000	10,000
Allowances	1,000[a]	4,200[b]
Net Taxable Income	9,000	5,800
Tax Liability	915[c]	1,102
Wages, Salaries, or Self-Employment	15,000	15,000
Allowances	1,000[a]	4,200[b]
Net Taxable Income	14,000	10,800
Tax Liability	1,801[c]	2,052
Wages, Salaries, or Self-Employment	20,000	20,000
Allowances	1,000[a]	4,200[b]
Net Taxable Income	19,000	15,800
Tax Liability	2,945[c]	3,002

SOURCE: Congressional Budget Office.

a. Personal exemption only.

b. Personal allowances assumed for Hall-Rabushka at 1984 income levels: $6,800 for married couples, $4,200 for single persons, $825 for dependents.

c. Tax liability according to 1980 law would be higher by approximately 30 percent of amount shown.

TABLE C. TAX LIABILITY UNDER HALL-RABUSHKA, 1984 LAW, AND 11.8 PERCENT TAX ON $100,000-$200,000 GROSS INCOME (AGI)[a]

	Hall-Rabushka (In thousands of dollars)	Tax on Gross Income (In thousands of dollars)
Adjusted Gross Income	47,050,833	47,050,833
Interest	(3,313,105)	---
Dividends	(4,627,306)	---
Capital Gains[b]	(3,038,496)	4,525,118
Income Subject to Tax	36,071,926	51,575,951
Allowances[c]	(2,728,774)	---
Taxable Income	33,343,152	51,575,951
Tax Rate	0.19	0.118
Tax	6,335,199	6,085,962
Tax Plus 19 Percent of Interest and Dividends	7,843,877	
1979 Law Tax	15,655,674	
1984 Law Tax[d]	12,054,869	

SOURCE: Congressional Budget Office.

a. Data from 1979 tax returns (latest detailed data available). 1980 law is identical to 1979 law.

b. Included portion deducted for Hall-Rabushka; excluded portion added for tax on gross income.

c. Assumes all returns are joint with one additional dependent.

d. 1979 law tax reduced by 23 percent.

TABLE D. TAX LIABILITY UNDER HALL-RABUSHKA, 1984 LAW, AND 11.8 PERCENT TAX ON $200,000-$500,000 GROSS INCOME (AGI)[a]

	Hall-Rabushka (In thousands of dollars)	Tax on Gross Income (In thousands of dollars)
Adjusted Gross Income	22,670,389	22,670,389
Interest	(1,710,145)	---
Dividends	(3,756,837)	---
Capital Gains[b]	(2,802,977)	4,813,515
Income Subject to Tax	14,400,430	26,853,904
Allowances[c]	(611,723)	---
Taxable Income	13,788,707	26,853,904
Tax Rate	0.19	0.118
Tax	2,619,854	3,168,761
Tax Plus 19 Percent of Interest and Dividends	3,658,581	
1979 Law Tax	9,219,010	
1984 Law Tax[d]	7,098,638	

SOURCE: Congressional Budget Office.

a. Data from 1979 tax returns (latest detailed data available). 1980 law is identical to 1979 law.

b. Included portion deducted for Hall-Rabushka; excluded portion added for tax on gross income.

c. Assumes all returns are joint with one additional dependent.

d. 1979 law tax reduced by 23 percent.

TABLE E. TAX LIABILITY UNDER HALL-RABUSHKA, 1984 LAW, AND 11.8 PERCENT TAX ON $500,000-$1,000,000 GROSS INCOME (AGI)[a]

	Hall-Rabushka (In thousands of dollars)	Tax on Gross Income (In thousands of dollars)
Adjusted Gross Income	6,571,180	6,571,180
Interest	(492,333)	---
Dividends	(1,475,424)	---
Capital Gains[b]	(1,522,168)	2,273,643
Income Subject to Tax	3,012,422	8,844,823
Allowances[c]	(75,518)	---
Taxable Income	2,936,904	8,844,823
Tax Rate	0.19	0.118
Tax	558,012	1,043,689
Tax Plus 19 Percent of Interest and Dividends	931,886	
1979 Law Tax	2,972,594	
1984 Law Tax[d]	2,288,897	

SOURCE: Congressional Budget Office.

a. Data from 1979 tax returns (latest detailed data available). 1980 law is identical to 1979 law.

b. Included portion deducted for Hall-Rabushka; excluded portion added for tax on gross income.

c. Assumes all returns are joint with one additional dependent.

d. 1979 law tax reduced by 23 percent.

TABLE F. TAX LIABILITY UNDER HALL-RABUSHKA, 1984 LAW, AND 11.8 PERCENT TAX ON $1,000,000 OR MORE GROSS INCOME (AGI)[a]

	Hall-Rabushka (thousands of dollars)	Tax on Gross Income (thousands of dollars)
Adjusted Gross Income	8,116,126	8,116,126
Interest	(562,437)	---
Dividends	(1,773,072)	---
Capital Gains[b]	(3,503,856)	5,241,112
Income Subject to Tax	2,276,761	13,357,238
Allowances[c]	(27,458)	---
Taxable Income	2,249,303	13,357,238
Tax Rate	0.19	0.118
Tax	427,368	1,576,154
Tax Plus 19 Percent of Interest and Dividends	871,114	
1979 Law Tax	4,073,808	
1984 Law Tax[d]	3,136,832	

SOURCE: Congressional Budget Office.

a. Data from 1979 tax returns (latest detailed data available). 1980 law is identical to 1979 law.

b. Included portion deducted for Hall-Rabushka; excluded portion added for tax on gross income.

c. Assumes all returns are joint with one additional dependent.

d. 1979 law tax reduced by 23 percent.

Senator JEPSEN. Thank you, Mr. Minarik.

Professors Hall and Rabushka, you now have more or less of an establishment critique of your plan. I thank Mr. Minarik for doing a very good job. We want these hearings to clear the air. It's quite a tax. It does have the pizaz of being simple and the connotation of being fair. And it has come to create a lot of interest. Anything that is simple and fair I think all Americans are for; and, therefore, we're going to air it well.

Thank you, Mr. Minarik.

At this time we will now recognizes Mr. Ture, who will elaborate on the whole thing, I understand.

STATEMENT OF NORMAN B. TURE, VISITING FELLOW, HERITAGE FOUNDATION

Mr. TURE. Thank you, Mr. Chairman.

Let me, first, go through the process of identifying myself for the purposes of the committee.

Since leaving the Treasury Department, I am a visiting fellow at the Heritage Foundation; and I am about to become chairman of the board of the Institute for Research on the Economics of Taxation. I have also resumed practice as an economic consultant. And these are the things that I am into and doing now. Nevertheless, none of the views reflected in the statement should be construed as those held by any of these organizations.

Senator JEPSEN. Is this a disclaimer?

Mr. TURE. It certainly sounds like it. [Laughter.]

I have found, as I am sure you will momentarily, that there is far from unanimous view about so-called flat rate taxes.

Let me further preface my remarks by saying that it is always a great pleasure to appear before this committee. You have virtually an unbroken record of taking the lead in addressing important issues in policy and doing so in objective context. I would, therefore, offer my commendations to you for extending that record by holding these hearings on the flat rate tax.

My discussion focuses on what I believe to be some of the principal issues raised by the flat rate tax proposals. I won't attempt to specify a flat rate tax in any significant detail, but I will attempt to identify some of the criteria which I think should guide.

I think we ought to begin with some discussion of the objectives which any flat rate tax proposal, presumably, ought to address. Any observer of the tax policy must certainly be struck by how suddenly, early this year, an interest in the flat rate tax appeared, and by the momentum that has developed for enacting this flat rate tax into law.

The idea of a flat rate tax has been for a long time. Indeed, as I recall, the kind of things that Henry C. Simons of the University of Chicago outlined as an ideal income tax in the year 1945–46 has a striking resemblance to most of the flat rate tax proposals now being offered. The novelty in current proposals is only in the variations in the basic outlines which are suggested. It somewhat strains the credulity to be asked to believe that the current surge of interest is attributable to the sudden discovery that the existing income tax is unfair, distortive, hideously complex, expensive to comply with, and frightfully costly to enforce. We've all known this for ages.

Could it be that the eruption of interest this year reflects an urgent concern to find some way to increase the Federal revenues in a way which might be used to convince taxpayers that good things are to be done to them even while additional taxes are extracted from them? If this is, indeed, the objective, if the motivation behind the present thrust for a flat rate tax really is to increase taxes in a relatively painless manner, then I think we should avoid these proposals like the plague. Indeed, any such proposal should move toward enactment only if some constitutional or statutory safeguard is provided to limit revenue increases.

There are, on the other hand, quite legitimate objectives which might be pursued by a properly designed flat rate tax. Let me turn to those now.

I would say first of all is tax neutrality or tax efficiency. Our present income tax is fairly characterized as a collection of excises. Of course, any and all taxes have an excise effect; they increase the cost of something or other relative to the cost of other things. Taxes change the relative cost which would prevail in the absence of taxes. And taxpayers respond to these changes in relative costs by changing their behavior. These behavioral changes result in changes in the composition of economic activity—in the allocation of the economy's production capability—and in the income claims generated by production. The greater the excise effect—the greater the effect on relative costs, the less neutral—the more distortive—the tax.

The present income tax, I think everybody will acknowledge, is a hodgepodge of such excises. Its weightiest excise effect, by far, is in raising the cost of working relative to the cost of leisure. An income tax also levies a heavy excise on saving, which is the same as capital formation.

Now, to be sure, both of these excise effects were reduced, materially, by the Economic Recovery Tax Act of last year. But the current legislation which forms the largest tax increases in our history, will go far toward restoring the former pre-ERTA bias against saving.

These are the basic excise effects of income tax. At the secondary level there are a great many provisions of the tax law which act to differentiate the burden of tax according to some particular activity, industry, or taxpayer characteristic. The income tax, in other words, imposes quite different excises on taxpayers, depending upon their activities or their attributes. These excise effects, alterations in relative costs, historically affect operation of the market mechanism and allocate production capability among the almost countless alternative uses.

Reducing these excises, their distortive effects of the tax system, and thereby improving the efficiency of the economy's use of its productive resources, should certainly be identified as the primary goal of tax policy. At least in the abstract it is certainly possible to design a tax which would alter relative costs, particularly the cost of saving relative to the cost of consumption, far less than the present income tax does. Moving toward tax neutrality in the sense herein defined should be the principal objective of any proposal for a flat rate tax. The extent to which the proposed tax would serve this neutrality objective should be the foremost criterion for its design.

A second objective is to reduce compliance costs and the need for

enforcement resources. Any law which requires the citizenry to incur costs in complying with or that requires commitment of resources by government to enforcement activities imposes a burden on the economy which should be minimized.

One of the claims made by flat-rate tax proponents is that such a tax would be far simpler in design; and, presumably, it would be far less difficult to comply with and would require far fewer resources allocated to government enforcement activities than the current income tax.

Now, surely, such simplification is an important objective to be pursued by the shift, if one is to occur, from the present income tax to a so-called flat rate tax. But this view is subject to important qualifications.

First, any such simplification and the cost savings it might provide must be weighed in terms of what they cost to achieve, in terms of shortfalls in attaining other objectives. The alterations in the tax base proposed in many of the flat rate tax proposals would increase the cost of saving relative to consumption. Increasing the excise effect of taxes on savings, in my judgment, is far too high a price to pay for simplification.

Second, much of the complexity in the income tax is the result of efforts to constrain the availability of tax shelters and their effectiveness to offset tax liabilities. Taxpayers pay a price for these tax shelters in the form of obtaining lower pretax returns on their savings. An efficient shelter-using taxpayer will allocate his savings to such investments only if the after-tax return thereto exceeds that which he can obtain from a nonsheltered investment. It is the possibility of reducing the marginal rate which provides a significant part of the inducement to find deductions, exemptions, deferrals, and what have you. The flat-rate structure, itself, reduces the payoff on tax shelters. A single or flat rate would contribute enormously to simplication, without any alteration in the statutory tax base, merely because, having been made relatively more costly, the sheltering provisions would be used to a far less extent.

Third, even if the tax base revisions were contemplated—the flat-rate tax proposals were, indeed, to afford simplification when fully implemented, an enormous price in additional complexity may have to be paid to get from where we are now to the fully-implemented flat rate tax. The only savings in compliance and enforcement costs might well exceed the transition costs, but we certainly should not ignore the transition costs in assessing the gains we expect from moving to a flat rate tax.

Finally, we would look to attain greater uniformity in tax treatment as one of the payoffs on a flat rate tax. The most appealing argument for many people, advanced on behalf of a flat rate tax, is it would be fairer than the present income tax. For many of the proponents, the gains in fairness are to be achieved not from flattening marginal tax rates but from tax base changes that their proposals contemplate. Few policy concepts, however, are more ambiguous and less useful as a practical matter for guiding policy than equity. For this reason uniformity of tax treatment should be substituted for fairness as the objective one might wish to pursue by replacing the income tax with a flat rate tax.

It doesn't necessarily follow that more nearly uniform tax treatment of taxpayers is fairer treatment, but greater uniformity is attainable while greater fairness, given its conceptual wispiness, is far more elusive. Greater uniformity may be justified in the interests of simplification, but as in that case its priority must be conditioned on its consistency with the primary objective of neutrality.

Let me turn now to the issues which I think are proposed by proposal for a flat rate tax.

Some of the most basic issues on tax policy are opposed by these proposals. And it seems to me good policy requires that these be carefully identified and resolved before we proceed toward implementation of these proposals.

The term "flat rate tax," as widely used, is a misnomer. Few of the proposals, possibly with the exception of the proposal of Hall and Rabushka and one or two others, call for a truly flat-rate marginal tax, a single rate applied to the tax base, and most of these proposals are, in fact, concerned more with broadening the tax base than they are with the flat rate. Flatness of rate and broadness of base, as Dr. Minarik has pointed out, are not necessarily tax policy buddies; we may well have one without the other. And quite different issues are raised by each.

The matter of how flat the tax rate structure should be addresses the conflict between considerations of economic efficiency and of fairness. The major reason for providing a single rate can be applied to whatever tax base is to minimize the excise effect of the tax in raising the cost of increasing one's income-producing capacity. Marginal or bracket rate graduation, by reducing more and more the net return to the earner from each additional dollar of income he or she produces, whether as compensation for labor services or as return on saving, makes it more and more costly at each bracket level to increase his or her income, whether by working more or by saving more. By the same token, graduated marginal rates levy an excise on increasing one's productivity. Whatever your rate is today, if you advance in productivity and expand your earnings, you are likely, under graduation, to subject those additional earnings not to the present rate but to a yet higher rate. The cost of progressive tax rates is a less progressive, less efficient economy, in which working, saving, and investment in productivity advance are penalized by the tax.

The question is: What do we get in exchange for this loss of efficiency resulting from marginal rate graduation? There are two standard answers. One is that the payoff is a fairer tax—a tax which conforms more closely than otherwise with ability to pay. The other is that we rely on graduation of tax rates as an instrument for redistributing or equalizing income and wealth. And neither answer is acceptable.

So far as ability to pay is concerned, there is a virtually unanimous consensus among tax theorists of all philosophic and ideological stripes that the conceptual content of that notion is too vague and too elusive to warrant attempting to shape tax policy around it. In any event, it does not follow that graduation of marginal rates that is called for to satisfy any operational, therefore inelegant, view of ability to pay. All that is required is that tax liability increases with income, consumption, or wealth, or whatever magnitude is deemed to be acceptable as a tax base with ability to pay as a criterion. And even if this require-

ment is construed as calling for more than proportionate increases in tax liability as one's tax base increases, it does not follow that the rate applied to the base must be graduated. For this purpose, it is the effective tax rate—the quotient of tax divided by tax base—that is relevant, not the marginal rates. Substantial graduation of effective rates is readily achieved with the imposition of a single, flat rate simply by exempting the first x dollars of the base from the tax. This may be achieved with a personal exemption system or by providing a zero-rate bracket in the tax base, any combination of such devices.

Disregarding philosophical reservations, there appears no evidence about the lack of achievement in equalizing income distribution. One must ask why marginal rate graduation is needed for income redistributing purposes. As in the case of ability to pay, it is not the shape of a marginal rate structure which is relevant in this regard; it is the shape of the effective rate structure. If the tax is to be used, however ineffectually, for leveling the distribution of income, this calls at most for graduated effective rates, which, as shown, can be readily provided by a system of personal exemptions or a zero-rate bracket along with a flat, marginal rate.

I arrive at the conclusion that there is not a meaningful reservation to be found in considerations either of fairness or of income distribution against a flat or single, marginal rate. This issue should be resolved in favor of a single rate with no graduation of marginal rates whatever. Any departure from a single rate almost certainly will lead to more and more graduation through time. One can easily foresee budgetary circumstances akin to those we now face exerting pressure to steepen the graduation then in place as a means of raising revenue without offending all taxpayers. This is, of course, diametrically opposed to good public policy which calls for offending everyone when taxes must be raised.

The second issue I wish to turn to is broadening the tax base.

To repeat, these issues, those concerning the tax base, are independent, or virtually so, from those pertaining to flatness of the tax rate structure. But as in the case of the tax rate issues, however, there is seeming conflict between considerations of economic efficiency and those of fairness which arise and must be resolved.

As suggested earlier, the existing income tax should be properly characterized as a mix of differential excises. By far the most consequential of these excise differences are the differentially heavy tax rates imposed on saving compared with consumption uses of income and working versus leisure. The efficiency concern focuses attention, in any proposals for redefining the tax base, on minimizing, if not entirely eliminating, excise differentials.

There is general and widespread agreement in this regard, but there is much less of a consensus as to the priority to be assigned the various excise differentials as targets for reduction. Those who prefer an expanded income tax base are prepared to accept the antisaving bias which is intrinsic to such a tax, and they emphasize, instead, eliminating or reducing differences in the tax treatment of income derived from differing saving outlets and differences between the tax treatment of income derived from capital and that obtained from providing labor services.

Implementing this approach would result in adding to the income tax base, and fully exposing to whatever tax rate structure is adopted,

substantial amounts of saving or the returns thereto which are only partially taxed under the present law. This would almost certainly result in greater uniformity of excise effect among differing capital uses of saving but only at the cost of greatly increasing the excise on all saving compared with consumption.

The alternative approach to base broadening places the emphasis where it properly belongs, on reducing the basic excise differential against saving. In fact, the basic attribute of a tax base which embodies this approach is that it results in the same percentage increase in the cost of saving as it does in the cost of consumption; it is, in other words, neutral between these alternative uses of one's resources. And in order to avoid the unfamiliarity of new terms, however misleading the term may be, let's call this tax base the expenditure tax base.

I don't want to go into the details of that base, but I can identify briefly its basic attributes. Neutrality of excise effect between consumption and saving requires either, (1), that all saving—reservation of income from consumption uses or equivalently, all purchases of sources of future income—be excluded from the tax base while all of the gross returns thereto, including the gross proceeds from the disposition of the capital instruments to which the saving is committed, are included in the tax base, or (2), including savings fully in the tax base but excluding completely all of the returns thereto. These alternatives are perfect equivalents, and each would equally well eliminate the present excise differential against saving. The choice between them should rest on practical considerations of compliance and enforcement costs.

Most proponents of this kind of a tax base have preferred the first alternative. With either alternative, the resulting tax base is far more nearly neutral between saving and consumption than is the expanded income base which, indeed, is likely to intensify the existing bias against saving. An additional advantage of the expenditure tax over the expanded income tax is that several of the principal sources of tax complexity would simply vanish of their own inutility.

Fully implementing this approach would not only remove virtually all of the differentially heavy tax burden on saving, it would also eliminate virtually all of the tax differentials among alternative forms of saving. It would, in short, achieve the second level tax neutrality among saving outlets pursued by the proponents of the expanded income tax base, while eliminating the basic bias against saving which the expanded income tax base would most certainly intensify.

One result of fully implementing the expenditure tax would be the elimination of tax shelters. The expenditure tax approach would automatically eliminate any tax differential in the determination of net returns among alternative investments. Tax sheltered investments would have to make it on their own and would survive, if at all, in substantially smaller volume than at present. This result, moreover, would be obtained without explicit legislative prohibition of such investments and without their further requirement or their addressing additional enforcement resources to make sure that such shelters could not be undertaken.

The expenditure tax confronts a fairness challenge. The ability-to-pay adherents maintain that income from capital has at least the same taxpaying capacity as income from labor. On this reasoning there

should be no distinction in tax treatment on the basis of where the income comes from or how it is used. The point which is overlooked in this assertion is that income which is saved is taxed far more heavily than income which is consumed; income from capital is taxed more heavily than income from labor. It is difficult to understand in what sense it is fair to tax income which is saved more heavily than income which is consumed or why it is fair to tax the returns on one's provision of capital services more heavily than compensation for providing one's labor services.

I think, therefore, that the so-called equity argument simply falls apart and has no real bearing on the issue.

Let me offer some concluding observations.

As these hearings and those that will be held next month will make unmistakeably clear, not all flat rate taxes are more equal. If the current thrust is to produce constructive results rather than tax backsliding which occurred last week, it will be necessary to discriminate carefully among the ever increasing number of proposals.

In doing so, the principal criterion should be the contribution of the proposed tax alternative to greater tax neutrality. In this respect, the focus should be on the big picture—eliminating the basic tax bias against saving and, secondarily, on eliminating differentials in tax on returns to different forms of saving. Close observation of this criterion calls for moving to an expenditure tax, not an expanded income tax, and for insistence on a truly flat marginal tax rate.

Now, this priority for neutrality does not, certainly, rule out or ignore either simplification—reducing costs in compliance and enforcement—or fairness. A truly flat rate expenditure tax would be far simpler than the present income tax, but it almost assuredly would not be free of complexity. Simplicity, however, must take its place in line as a tax criterion. The ultimate in tax simplicity would be a head tax, but few policy makers, if any, would urge that as the basic tax in our system.

Similarly, no one would deliberately design a tax to be unfair, though with the best intent and greatest effort to produce the fairest possible tax, one is likely to find a thin consensus to confirm one's success. If for no other reason than we don't know what tax fairness really is, it should take a back seat to other criteria, principally neutrality, in the design of a flat rate, broad based tax.

Let us not delude ourselves that a flat rate, broad based tax will be easy to come by. The difficulty is not in designing the tax so much as it is in figuring out how to get from here to there without serious injury to one innocent bystander after another—taxpayers. To a huge extent present business and household arrangements, transactions, and conduct of daily affairs are designed to accommodate the existing tax regimen's exigencies with a minimum of pain and cost. Any abrupt change would prove economically costly. The effort to implement a flat rate, broad based tax will require a careful, probably extended transition, which will present a great many very challenging problems.

Finally, I have not sought in my discussion to address the subject of social security financing, a subject that was included in the request for testing. In itself that is a subject of suge dimension and great difficulty, to which many separate sets of hearings might well be directed. I trust that there was no suggestion that flat rate taxes per se offer

any solution to these problems. We can, after all, if we were to deem it appropriate, fold the financing of the social security system, in whole or in part, into the general revenue system, whatever the character of the taxes in that system. Flat rate taxes afford no magic formula for solving the social security system's financing problems in any greater degree than they are at present.

Let me, again, commend the committee for taking the lead in examining the subject of flat rate taxes. In the abstract there is great promise in a properly designed flat rate tax system for affording a tax environment far more nearly neutral, and therefore far less repressive, of economic efficiency than the one we now have. But we should avoid extravagant claims about what, in this real world, we can expect. We need a very hard-headed, critical, in-depth examination of the proposals now being offered, and very deliberate and careful progress, not the pellmell and intemperate tax legislation we saw last week. This committee can contribute much to assuring that the appropriate examination is undertaken at the appropriate time.

Thank you.

[The prepared statement of Mr. Ture follows:]

Prepared Statement of Norman B. Ture

It is, as always, a great pleasure to appear before this Committee. The Committee has a well-nigh unbroken record of taking the lead in addressing important issues of public economic policy and doing so in an objective context. Let me offer you my commendations for extending that record by holding these hearings on the flat-rate tax.

My discussion focuses on what I believe to be some of the principal issues raised by flat-rate tax proposals. I shall not attempt to specify a flat-rate tax in any significant detail, although I will identify the criteria which, I believe, should guide the design of the tax. The Committee must surely have discovered that most of the examinations of the flat-rate tax proposals have been far more concerned with design details and with guesses about shifts in the income levels distribution of tax liabilities under each of the alternative sets of specifications than about issues; few of these examinations have sought to provide a careful analysis of purposes and objectives, and few, accordingly, satisfactorily show that tax design, objectives and criteria are consonant.

Objectives

Any observer of the tax policy scene certainly must be struck by how suddenly, early this year, the interest in a flat-rate tax appeared, and by the momentum that has developed for enacting a flat-rate tax into law. The idea of a flat-rate tax has been around for a long time; the novelty in the current proposals is only in the variations in the basic outlines which are suggested. It somewhat strains the credulity to be asked to believe that the current surge

of interest is attributable to the sudden discovery that the existing income tax is unfair, distortive, hideously complex, expensive to comply with, and frightfully costly to enforce. We've all known this for ages. Could it be that the eruption of interest this year reflects an urgent concern to find some way to increase the Federal revenues in a way which might be used to convince taxpayers that good things are to be done to them even while additional taxes are extracted from them? If this is, indeed, the objective, if the motivation behind the present thrust toward "flat-rate" taxes really is to increase taxes in a relatively painless manner, then I think we should avoid these proposals like the plague. Indeed, any such proposal should move toward enactment only if some constitutional or statutory safeguard is provided to limit revenue increases.

There are, on the other hand, quite legitimate objectives which might be pursued by a properly designed flat-rate tax.

Tax Neutrality

Our present income tax is fairly characterized as a collection of excises. The man in the street readily and correctly identifies the nature of an excise in terms of its principal effect—to raise the cost of the thing subject to the excise compared to other things. An excise on gasoline raises its cost. People respond by buying less gasoline, shifting their purchases to other (now) relatively less expensive things. With less gasoline sold, less is produced, less production resources are devoted to gasoline production, and less income is generated by that production.

Any and all taxes have this excise effect of increasing the cost of some thing(s) relative to the cost of other things. Taxes change the relative costs which would prevail in the absence of taxes. Taxpayers respond to these changes in relative costs by changing their behavior. These behavioral changes result in changes in the composition of economic activity—in the allocation of the economy's production capability—and in the income claims generated by production. The greater the excise effect—the greater the effect on relative costs, the less neutral—the more distortive—the tax.

The present income tax is a hodgepodge of such excises. Its weightiest excise effect is in raising the cost of working r ative to the cost of "leisure" (all those uses of one's time and resources other than those for which there is a market-determined compensation). The income tax also levies a heavy excise on saving (equals investment).[1] To be sure, both of these excise effects were materially reduced by the Economic Recovery Tax Act (ERTA) of 1981, although the current tax legislation—the largest tax increases in our history—will go far toward restoring the pre-ERTA bias against saving.

These are the basic excise effects in the income tax. At a secondary level, there are a great many provisions of the tax law which act to differentiate the burden of the tax according to a particular activity, industry, or taxpayer characteristic. The income tax, in other words, imposes quite different excises on taxpayers, depending on their activities or other attributes. These excise effects—alterations in relative costs—distort the operation of the market mechanism in allocating production capability among the almost countless alternative uses.

Reducing these excises, their distortive effects of the tax system, and thereby improving the efficiency of the economy's use of its productive resources, should certainly be identified as the primary goal of tax policy. A flat-rate tax is widely believed to be far more neutral and far less beset with excise characteristics than the present income tax. At least in the abstract, it is certainly possible to design a tax which would alter relative costs, particularly the cost of saving relative to the cost of consumption, far less than the present income tax. Moving toward tax neutrality in the sense herein defined should be the principal objective of any proposal for a flat-rate tax. The extent to which the proposed tax would serve this neutrality objective should be the foremost criterion for its design.

Reducing Compliance Costs and the Need for Enforcement Resources

Any law, regulation, or public institutional arrangement which requires the citizenry to incur costs in complying and/or the commitment of resources by government to enforcement activities imposes a burden on the economy which should be minimized. This burden is the output of goods and services which might have been produced by the resources devoted to compliance and enforcement.

The present income tax has a track record, virtually unbroken over the years, of constantly increasing complexity which has, year by year, expanded both compliance and enforcement costs. One of the claims made by flat-rate tax proponents is that such a tax would be far simpler in design; presumably, it would be far less difficult to comply with and would require far fewer resources allocated to government enforcement activities.

Certainly, such simplification is an important objective to be pursued by the shift, if it is to occur, from the present income tax to a "flat-rate" tax. For the most part, proponents of "flat-rate" taxes fail to point out that it is the change in the tax base which is contemplated by their proposal, not the flatness of rate per se, which is to achieve this simplification and reduction in compliance and enforcement costs. This view is subject to important qualifications.

First, any such simplification and the cost savings it might provide must be weighed in terms of what they cost to achieve, in terms of shortfalls in attaining other objectives. The alterations in the tax base proposed in many of the "flat-rate" tax proposals would increase the cost of saving relative to consumption. Increasing the excise effect of taxes on saving is too high a price to pay for simplification.

Second, much of the complexity in the income tax is the result of efforts to constrain the availability of tax shelters and their effectiveness in reducing tax liabilities. Taxpayers pay a price for these tax shelters in the form of obtaining lower pretax returns on their saving. An efficient shelter-using taxpayer will allocate his saving to such investments only if the after-tax return thereto exceeds that which he can obtain from a nonsheltered investment. In other words, he'll undertake the sheltered investment only if the marginal tax rate thereupon is sufficiently lower than that on nonsheltered investment, and is at least enough to offset the higher pretax rate of return obtainable on the latter. To a significant extent, this search for shelters is a result of marginal rate graduation. It's the possibility of reducing the marginal rate which provides a significant part of the inducement

to find deductions, exemptions, deferrals, etc. Flattening the rate structure, in itself, reduces the payoff on tax shelters. A single or flat rate would contribute enormously to simplification, without any alteration in the statutory tax base, merely because, having been made relatively more costly, the sheltering provisions would be used to a far less extent.

Third, even if the tax base revisions contemplated in flat-rate tax proposals were, indeed, to afford simplification when fully implemented, an enormous price in additional complexity may have to be paid to get from where we are now to the fully-implemented flat-rate tax. The ultimate savings in compliance and enforcement costs might well exceed the transition costs, but we certainly should not ignore the latter in assessing the gains we expect from moving to a flat-rate tax.

Greater Uniformity in Tax Treatment

The most appealing argument, for many people, advanced on behalf of the flat-rate tax is that it would be fairer than the present income tax. It's obvious that for many of the proponents, the gains in fairness are to be achieved not from flattening marginal tax rates—indeed, this is widely perceived as resulting in a loss of equity—but from the tax base changes their proposals contemplate. This illustrates the fact that few tax policy concepts are more ambiguous and less useful as a practical matter for guiding policy than equity.

For this reason, uniformity of tax treatment should be substituted for fairness as the objective one might wish to pursue by replacing the income tax

with a flat-rate tax. It does not necessarily follow that more nearly uniform tax treatment of taxpayers is fairer treatment, but greater uniformity is attainable while greater fairness, given its conceptual wispiness, is far more elusive. Greater uniformity may be justified in the interests of simplification, but as in that case its priority must be conditioned on its consistency with the primary objective of neutrality.

Issues

The broadening enthusiam for a flat-rate tax might lead one to believe that no significant issues are raised by adopting such a tax. In fact, several of the most basic issues of tax policy are involved, and good policy- making requires that these be carefully identified and resolved by consensus.

Flatness of Rate

As already suggested, the term flat-rate tax, as widely used, is a misnomer. Few of the proposals call for a truly flat-rate marginal rate—a single rate applied to the tax base, and most of these proposals are in fact concerned more with broadening the tax base—than with a flat tax rate. Flatness of rate and broadness of base are not necessarily tax policy buddies; we may well have one without the other. And quite different issues are raised by each.

The matter of how flat the tax rate structure should be addresses a conflict between considerations of economic efficiency and of fairness. The major reason for providing a single rate to be applied to the tax base is to minimize the excise effect of the tax in raising the cost of increasing one's income-producing capacity. Marginal—bracket—rate graduation, by reducing

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more and more the net return to the earner from each additional dollar of income he or she produces—whether as compensation for labor services or as return on saving—makes it more and more costly to increase his or her income, whether by working more or by saving more. By the same token, graduated marginal rates levy an excise on increasing one's productivity. The cost of progressive tax rates is a less progressive, less efficient economy, in which working, saving, and investment in productivity advance is penalized by the tax.

The question is what do we get in exchange for this loss of efficiency resulting from marginal rate graduation. There are two standard answers. One is that the payoff is a fairer tax—a tax which conforms more closely than otherwise with "ability-to-pay." The other is that we rely on graduation of tax rates as an instrument for redistributing—equalizing—income and wealth. Neither answer is acceptable.

So far as ability-to-pay is concerned, there is a virtually unanimous consensus among tax theorists that the conceptual content of that notion is too vague and elusive to warrant attempting to shape tax policy around it. There is a broadly held and solidly based view that, whatever the conceptual construction (and whatever the utility-maximizing function that is assumed), there is little reason to believe annual income is an adequate measure of taxpaying ability; consumption is deemed by some to be far better, while others hold out for wealth. And no matter which is used, there are extraordinary problems of definition to be resolved if there is to be any confidence that the chosen economic variable has anything to do with ability to pay.

In any event, it does not follow that graduation of marginal rates is called for to satisfy any operational—inelegant—view of ability to pay. Indeed, all that is required is that tax liability increases with income, consumption, or wealth, or whatever magnitude is deemed to be acceptable as a tax base with ability to pay as a criterion. And even if this requirement is construed as calling for more than proportionate increases in tax liability as one's tax base increases, it does not follow that the rate applied to the base must be graduated. Indeed, for this purpose, it is the effective tax rate—the quotient of tax divided by tax base—that is relevant, not the marginal rates. Substantial graduation of effective rates is readily achieved with the imposition of a single—flat—marginal rate simply by exempting the first X dollars of the base from the tax. This may be achieved with a personal exemption system or by providing a zero-rate bracket in the tax base.

The will o' the wisp character of vertical equity was noted and documented very early on in the development of tax theory. It is seldom, if ever, addressed in rigorous discussions of the proper shape of the tax rate structure. Indeed, Henry C. Simons, who probably had the weightiest and most persuasive influence on contemporary thought about such matters, often asserted that the real and only purpose to be served by an income tax with graduated marginal tax rates is to assist in equalizing the distribution of income and wealth. We should not need a reminder that there is far from a substantial consensus that equality of income and wealth distribution is an appropriate objective to be served by public policy. But even if the contrary were true, we should be brought up short by the fact that marginal rate graduation, itself, has obviously been almost, if not completely, ineffectual to this purpose.[2]

Disregarding philosophical reservations and the empirical evidence about the lack of achievement in equalizing income distribution, one must ask why marginal rate graduation is needed for income redistributing purposes. As in the case of ability to pay, it is not the shape of the marginal rate structure which is relevant in this regard; it is the shape of the effective rate structure. If the tax is to be used, however ineffectually, for leveling the distribution of income, this calls at most for graduated effective rates, which, as shown, can be readily provided by a system of personal exemptions or a zero-rate bracket and a single or flat marginal rate.

I arrive at the conclusion that there is not a meaningful reservation to be found in considerations of fairness or income distribution against a flat or single marginal rate. This issue should be resolved in favor of a single rate, with no graduation of marginal rates whatever. Any departure from a single rate almost certainly will lead to more and more graduation through time. One can easily foresee budgetary circumstances akin to those we now face exerting pressure to steepen the graduation then in place as a means of raising revenue without offending all taxpayers. This is, of course, diametrically opposed to good public policy which calls for offending everyone when taxes must be raised.

Broadening the Tax Base

Issues concerning the tax base are independent—or virtually so—from those pertaining to flatness of the tax rate structure. But as in the case of the tax rate issues, there is a seeming conflict between considerations of economic efficiency and those of fairness which arises in connection with the tax base.

As suggested earlier, the existing income tax is properly characterized as a mix of differential excises. To some extent, the source of the variance in rate from one excise to another in the tax is difference in the statutory rates. But more important than explicit rate differentials is the difference in the extent to which various expenses and receipts are recognized for tax purposes, as well as the timing of such recognition. To repeat an earlier assertion, by far the most consequential of the excise differences are the differentially heavy rates imposed on saving compared with consumption uses of income and working versus "leisure."[3] The efficiency concern focuses attention, in any proposals for redefining the tax base, on minimizing, if not eliminating, these excise differentials.

Although there is general agreement in this regard, there is much less of a consensus as to the priorities to be assigned the various excise differentials as targets for reduction. Those who prefer an expanded income tax base are prepared to accept—often they simply ignore—the anti-saving bias which is intrinsic to such a tax and emphasize eliminating or reducing differences in the tax treatment of income derived from differing saving outlets and differences between the tax treatment of income derived from capital and that obtained from providing labor services. Many of the proponents of this approach perceive the (limited) neutrality goal they identify as indistinguishable from an equity goal often articulated as equal tax treatment of equally situated taxpayers. Implementing this approach would result in adding to the income tax base, and fully exposing to whatever tax rate structure is adopted, substantial amounts of saving or the returns thereto which are only partially taxed under present law. This would very likely

result in greater uniformity of excise effect among differing capital uses of saving while significantly increasing the excise on all saving compared with consumption.

The alternative approach to base broadening places the emphasis where it properly belongs—on reducing the basic excise differential against saving. Some of the designations of the tax base resulting from this approach—e.g., the "consumption-based income tax," the "expenditure tax"—are misleading or actually pejorative in connotation. In fact, the basic attribute of this tax base is that it results in the same percentage increase in the cost of saving and of consumption; it is, in other words, neutral between these alternative uses of one's resources. To avoid the unfamiliarity of new terms, let's call this tax base the expenditure tax base.

Without detailing the design of the expenditure tax, its basic attributes can be briefly delineated. Neutrality of excise effect between consumption and saving requires either that 1) all saving—reservation of income from consumption uses or, equivalently, all purchases of sources of future income—be excluded from the tax base while all of the gross returns thereto (including the gross proceeds from the disposition of the capital instruments to which the saving is committed) are included in the tax base, or 2) saving is included fully in the tax base but all the returns thereto are excluded. These alternatives are perfect equivalents; each equally well would eliminate the present excise differential against saving. The choice between them should rest on practical considerations of compliance and enforcement costs. Most proponents of the expenditure tax have preferred the first alternative.

With either alternative, the resulting tax base is far more nearly neutral between saving and consumption than is the expanded income base which, indeed, is likely to intensify the existing tax bias against saving.[4] An additional advantage of the "expenditure" tax over the expanded income tax is that several of the principal sources of tax complexity would simply vanish. Two obvious examples are capital gains and capital recovery provisions of all sorts. With exclusion of current saving from the tax base, there would be no occasion to compute capital gains or losses; all of the proceeds from the disposition of assets would be included in taxable income, not merely the gains or losses in the proceeds. Again, by reason of the exclusion of saving, (i.e., the purchase of sources of future income) from the tax base, there would be no reason to attempt to allocate the recovery of the investment against the income it generates over time. The exclusion of saving is precisely the same as expensing of capital outlays, obviating any additional depreciation, depletion, or other capital recovery.[5]

Fully implementing this approach would not only remove virtually all of the differentially heavy tax burden on saving, it would also eliminate virtually all of the tax differentials among alternative forms of saving. It would, in short, achieve the second level tax neutrality among saving outlets pursued by proponents of the expanded income tax base, while eliminating the basic bias against saving which the expanded income tax base would most likely intensify.

One result of fully implementing the expenditure tax would be the elimination of tax shelters. The expenditure tax approach would automatically eliminate any tax differential in the determination of net returns among alternative investments. Tax sheltered investments would have to make it on their own and

would survive, if at all, in substantially smaller volume than at present. This result, moreover, would be obtained without explicit legislative prohibition of such investments.

The expenditure tax confronts a fairness challenge which, when closely examined, confounds arguments about uses of income with those about who the users are. The ability-to-pay adherents maintain that income from capital has at least the same taxpaying capacity as income from labor; on this "reasoning" there should be no distinction in tax treatment on the basis of where the income comes from or how it is used. The point which is overlooked in this assertion is that income which is saved is taxed far more heavily than income which is consumed; income from capital is taxed more heavily than income from labor. It is difficult to understand in what sense it is fair to tax income which is saved more than income which is consumed or why it is fair to tax the returns on one's provision of capital services more heavily than compensation for providing one's labor services.

This challenge is generally finessed by those who advance the fairness argument by turning to the empirical question of who does the saving. It is certainly true that the expenditure tax would shift tax liabilities between those who would and those who would not save compared to the distribution of liabilities under present law. It is also highly likely that those few people in the upper end of the income scale save more of their income than those at the bottom. But this is a minor matter. Individuals at the bottom or lower end of the income scale can be substantially relieved of most tax liability under a really flat-rate expenditure tax by an adequate zero-rate bracket. Those at the top will reduce their tax liabilities only insofar as they

continue to be big savers, with beneficial effects for the entire economy. As in the case of the fairness challenge to flatness of marginal rates, there is less in this fairness argument than meets the eye.

Concluding Observations

As these hearings will make unmistakeably clear, not all flat-rate taxes are born equal. If the current thrust is to produce constructive results rather than the tax backsliding which occurred last week, it will be necessary to discriminate carefully among the increasing number of proposals.

In doing so, the principal criterion should be the contribution of the proposed tax alternative to greater tax neutrality. In this respect, the focus should be on the big picture--eliminating the basic tax bias against saving and secondarily on eliminating differentials in tax on returns to different forms of saving. Close observation of this criterion calls for moving to an expenditure tax, not an expanded income tax, and for insistence on a truly flat marginal tax rate.

This priority for the neutrality criterion does not, certainly, rule out or ignore either simplification--reducing costs of compliance and enforcement--or fairness. A truly flat-rate expenditure tax would be far simpler than the present income tax, but it most assuredly would not be free of complexity. Simplicity, however, must take its place in line as a tax criterion. The ultimate in tax simplicity would be a head tax, but few policy makers, if any, would urge it as the basic tax in our system.

Similarly, no one would deliberately design a tax to be unfair, though with the best intent and greatest effort to produce the fairest possible tax, one is likely to find a thin consensus—if any—to confirm one's success. If for no other reason than we don't know what tax fairness really is, it should take a back seat to other criteria, principally neutrality, in the design of a flat-rate, broad-based tax.

Let us not delude ourselves that a flat-rate, broad-based tax will be easy to come by. The difficulty is not in designing the tax so much as it is in figuring out how to get from here to there without serious injury to one innocent bystander after another—taxpayers. To a huge extent, present business and household arrangements, transactions, and conduct of daily affairs are designed to accomodate the existing tax regimen's exigencies with a minimum of pain and cost. Any abrupt change would prove economically costly. The effort to implement a flat-rate, broad-based tax will require a careful, probably extended transition, which will present a great many very challenging problems.

Finally, my discussion has not addressed the question of Social Security financing. That is itself a subject of huge dimension and great difficulty to which a separate set of hearings might well be directed. I trust there was no suggestion that flat-rate taxes per se offer any solution to these problems. We can, if we were to deem it appropriate, fold the financing of the Social Security System, in whole or in part, into the general revenue system, whatever the character of the taxes in that system. Flat-rate taxes afford no magic formula for solving the Social Security System's financing problems in any greater degree than our present taxes.

Again, commendation is due the Committee for taking the lead in examining the subject of "flat-rate" taxes. In the abstract, there is great promise in a properly designed flat-rate tax system for affording a tax environment far more nearly neutral and therefore far less repressive of economic efficiency than the one we now have. But we should avoid extravagant claims about what, in this real world, we can expect. We need a very hard-headed, critical, in-depth examination of the proposals now offered, and very deliberate and careful progress, not the pell-mell and intemperate tax legislation we saw last week. This Committee can contribute much to assuring that the appropriate examination is undertaken at the appropriate time.

Footnotes

[1]For an extended discussion of these excise effects—of the tax bias against saving—prevailing before ERTA, see Norman B. Ture and B. Kenneth Sanden, Effects of Tax Policy on Capital Formation, Financial Executives Research Foundation, New York (1977), and Ture, "Supply Side Analysis and Public Policy," Essays in Supply Side Economics, David G. Raboy, ed., Institute for Research on the Economics of Taxation (IRET), Washington, D.C. (1982), pp.9-28.

[2]The ultimate results of equality of income achieved by the tax system, and the reasons why the graduated income tax has made no significant progress toward such equality is explored in Norman B. Ture, "Taxation and the Distribution of Income," Principal Paper in Wealth Redistribution and the Income Tax, D.C. Heath and Company, Lexington, Massachusetts, 1978.

[3]Explanations and illustrations of these biases are to be found in Ture and Sanden, op. cit., and Ture, "Supply Side Analysis and Public Policy," op. cit., pp. 9-28.

[4]To cite a single example, presumably an expanded income tax base would include as part of a covered employee's taxable income his employer's contribution to a pension plan on his behalf. If exception were to be made on this score, it is more than likely that other exceptions would proliferate. The ultimate outcome might well be a larger tax base than the present one, but with little less arbitrariness in its composition.

[5]With this treatment of saving (= capital outlays) and the returns thereto, there is clearly no reason to distinguish the tax treatment between new and used assets, as some flat-rate tax proposals would. Any such differentation would alter the relative prices of new and used assets and thereby introduce a needless unneutrality and distortion of investment decisions.

Representative REUSS. Thank you, Mr. Ture.

Mr. Hall and Mr. Rabushka, your flat-rate post card, I must say, fascinates me. I think I can say it is the most imaginative and exciting post card since one that was offered me as I walked through the Place Pigale in Paris not so long ago. [Laughter.]

I do have a question about its fairness, however.

Am I right that under your proposal—and I try to read it carefully—let's assume a regional food distribution corporation that has a net income of $10 million a year—pays out a $10 million a year in dividends to stockholders. Under present law the corporation would pay a marginal tax rate of 46 percent and the stockholders, on the dividends, would pay a—those who were in the top bracket would pay a rate of 50 percent. That is down from 70 percent prior to Kemp-Roth. Under your proposal the corporation would pay a rate of 19 percent rather than 46 percent, and the individual would pay a rate of zero rather than 50 percent; is that right?

Mr. HALL. That is quite correct. You have made a highly theoretical statement, however, about how the present tax system works; because all of the incentives are for the individual to receive the dividends by some complicated process that escapes taxation at the individual level.

Representative REUSS. I wish you would tell me what that is, because I receive dividends, and damn it, I have to pay a tax on them. It is outrageous.

Mr. HALL. Well, the first step is to channel dividends through children. That's a big step forward.

Representative REUSS. Well, when you think of a good dodge for me, let know; prior to next April, if possible. [Laughter.]

Mr. HALL. The second point would be that a great deal of dividends flow to retirement funds which are untaxed, will only later be taxed at a generally lower rate.

However, when we get done, the taxation of dividends today, and, in general, corporate income, is done at very high rates. And that is a tremendous disincentive to the capital formation in the U.S. economy. The over taxation of productive capital—and this remains true even with the ERTA legislation which improves the situation somewhat—but the taxation of capital, especially with the type of investment that is undertaken by corporations and subsequently paid out in returns and paid out in dividends, is almost confiscatory taxation of that type of activity. The result has been to channel capital away from that type activity and into those activities that are eligible for tax shelters treatments.

Any type of investment for which a great deal of borrowing could be made, and that would be typical of tax shelters, any kind of portable capital, is very well treated under the tax law, whereas large plant and equipment investment of the type undertaken by corporations are very heavily taxed. The distortion that is put on the tax—on the economy—then, of course, is very severe.

We propose that taxation of all types of investment proceed equally and at a low rate. And we feel that that is important. Now, of course, that results in tremendous reduction of tax rates on certain types of income, and we readily concede that reduced taxation and return to investment is a very important part of restoring economic growth, and we pay for it.

Representative REUSS. Well, Mr. Minarik, we have heard that large corporations and clippers of coupons would have their taxes practically done away with. We've also heard that the proposal of the two gentlemen from the Hoover Institute is to give poverty taxpayers a low income exemption.

Would you agree with the following statement? "With tax cuts at the top and the bottom, it is the middle that is left holding the bag."

Mr. MINARIK. I think I said that about a week ago, Congressman Reuss.

Representative REUSS. I thought you would agree.

Mr. MINARIK. I see you subscribe to my clipping service, too. [Laughter.]

Representative REUSS. Would you reaffirm your position?

Mr. MINARIK. It is pretty much a mathematical necessity, if you have a certain amount of tax burden to go around in the short run, which we do, and if you come up with a tax system that reduces one individual's tax liability and you want to collect the same amount of revenue, that tax cut has got to be made up somewhere else. And most of the flat rate tax proposals do have the characteristic that they cut tax liabilities for the upper income taxpayers, and when they expand the lower income relief they also cut the tax liabilities for low income taxpayers. So, the tax burden is pushed into the middle from both ends.

Representative REUSS. Would it make sense, sir, to do what the gentlemen from the Hoover Institute suggest about doing in loopholes, preferences, exemptions, and deductions, perhaps with a little more reserve than they do, but that general principle of loophole closing, and then reduce brackets generally and equitably so as to yield the same amount of revenue but at a lower bracket, but preserve a generally progressive tax system, wouldn't that really be the best alternative?

Mr. MINARIK. Well, as a nonpartisan employee of the Congress, I am not empowered to tell the Congress what is the best thing to do.

Representative REUSS. Well, don't speak for the Congressional Budget Office, just speak as a member of the middle class.

Mr. MINARIK. You really have me pegged, sir. [Laughter.]

Representative REUSS. Do you resist my suggestion, for middle-class people—I'm only talking about 90 percent of Americans—that what I suggest would be better than the Hoover Institute's idea?

Mr. MINARIK. Well, there have been people who have proposed that particular course of action. As with everything else, there are pluses and minuses; you don't get a perfectly flat rate, and, therefore, the simplicity of the system is somewhat reduced. On the other hand, you don't have the weeping, and wailing, and gnashing of teeth that comes about when you push the tax burden around from one taxpayer to another. And those are pluses and minuses that just have to be weighed in the balance. Some people would say it is favorable, some would say it is unfavorable.

Mr. RABUSHKA. Could I comment on your question?

Representative REUSS. Yes.

Mr. RABUSHKA. Your question raises a very important point, and I think there are several answers to it.

The reason we have come out for this uniform single flat rate on all types of income is because we think, against all the criteria of tax simplification of the form, it's a much more effective device. I think there are two problems minimally, apart from the ones Professor Hall mentioned in his statement, with having this form of even mild progressivity, one of which is economic and one of which is political. It doesn't take very long in the United States for taxpayers to confront the 40 or 50 percent bracket. Indeed, a good part of the middle-class citizens are in the 50 percent bracket, and those are the people who pay a good part of the taxes. And while their average tax is nowhere near that high, the point, I think, that most economists would argue is that their economic behavior is not conditioned by their average tax burden but by the marginal tax rate on the next unit of work, saving, or investment. And I think the key to a flat rate is to make sure that we don't progressively deter the kind of work, and saving, and effort which we want to get the economy onto a higher growth pattern.

So, I think it is very important to draw a distinction between how marginal rates affect people and how average rates affect people. And we hit those high marginal rates ever so quickly in the middle class.

The second point is equally important, and it is the politics of graduation. If we take, for example, the most talked about progressive one, the Bradley-Gephart bill, it is designed so that 80 percent pay at one rate and the other 20 percent pay at a surcharge to a steeply higher rate; and the impact in the end is that everytime you want to raise more revenues a political coalition is there so the 80 percent levies additional surcharges on the other 20 percent. A couple more of those and we're back to the 50-percent marginal rates we have and all the leakage problems that Professor Hall pointed out.

So, I think the leakage problem is really a very strong argument against progressivity. The political argument is a very strong one. And the effect of having a whole middle class facing very, very high marginal rates is one in which I think it is very important to focus that part of your analysis there. And the low flat marginal rate puts an end to bracketry, puts an end to all of the disincentive effects we face today with our progressive system.

Mr. TURE. May I add a comment to those?

I would not suggest for a moment that consideration of income distribution and changes in tax liability in any such proposal should be disregarded. But it certainly should not be made the primary criterion for evaluating any of these proposals either.

One of the things that we all do, just because it is the simplest thing to do, is to assume that with any of these proposals everybody remains, in terms of behavior, completely inert and nobody does anything different from what he is doing under the present tax procedure. And we count on that for purposes of measuring what the change and shift in distribution of tax liability by income level. But I think that is an absolutely specious assumption; rather, what we ought to do is take the time and trouble to figure out what people will do in response to the changes in the excise which this or any other proposal involved, and then see where they will be in the income distribution after having changed their liabilities, then determine whether or not, on the basis of some criteria or another, we like that distribution of liabilities better than the one we now have.

Incidentally, it makes a fascinating inquiry to find out what is better or worse as a distribution of tax liabilities.

Senator JEPSEN. I would like to ask a question that I would like to ask the three, maybe four, of you to respond to.

What do you interpret the word "progressivity" to mean in tax deductions?

Mr. MINARIK. There are several technical definitions, Senator.

Senator JEPSEN. What is your definition?

Mr. MINARIK. They refer to different things; you can't really choose one as opposed to another. Mr. Ture has mentioned that you can look at a distribution of effective tax liabilities that increases the share of income as being a progressive system. Some people say that the marginal tax rates, themselves, have to go up to have a progressive system. In measuring progressivity, other people look at the distribution of after-tax income and to what extent is that distribution changed by the imposition of the tax system.

So, as an example, in the deliberation on last tax year's bill, the Economic Recovery Tax Act, there was an argument going back and forth between people for the bill and people against the bill as to whether it was or was not a progressive tax cut. Some people said that the tax cuts took the same percentage off the tax liability in every income class, and therefore didn't interfere with the progressivity of the tax system and, therefore it was a progressive tax cut. Other people used a different criterion, and they said that that tax cut gave people with higher incomes a bigger percentage increase in their after-tax income, and therefore it was a regressive tax cut. I don't think you can count the vote on that bill as being a decision on which of those two theories prevailed. The vote was probably taken on other criteria; but it's just an example that of progressivity is different things to different people.

Senator JEPSEN. In your opinion, those who advocated it, how they would express or define "progressive", what do they——

Mr. MINARIK. Again, it varies. Mr. Ture is talking about a flat rate tax with exemptions for low incomes as being progressive. There are people who do not like any form of flat rate system because the tax rates are constant all the way across the income scale. They don't go up; and they feel that the tax rates have to go up for the system to be progressive and find that criterion to be acceptable. So, I don't think we're going to settle on a definition of that term.

Mr. TURE. Senator Jepsen, in an attempt to answer the question, let me point out that advocates of progressivity can be very agile. For the most part, what they have in mind is that the average tax rate rises from one income level to another. As has been pointed out, there are all sorts of tax rate structures which produce that. However, when you point that out to them, if they are still dedicated to progression in marginal tax rates, they will then switch their argument to the shape of the distribution of tax liabilities by income level. And then what we get is some picture of a "U"-shaped distribution. That is an entirely different issue which has more to do with who is where in the income distribution than it has to do with the structure of the tax system.

Then, finally, as Mr. Minarik has pointed out, you can play thousands of different games with respect to what is really a progressive structure.

Some would say it is not really the fact that each succeeding marginal rate is higher than the one before, but that it has to be more and proportionately higher. Some of our friends in France love that kind of approach and play thousands of games with it. I would simply point out that in all the examinations of tax theory that I know of, there has been no satisfactory resolution of what, in terms of any ability-to-pay notion, is called for by way of the shape of a marginal rate structure, none. One of the world's most famous scholars addressed the subject and said that the moment you depart from proportionality—from a single, flat rate—you are like a ship at sea without a rudder or a compass.

Senator JEPSEN. Well, does it seem to you that those who push the progressive connotation feel that that takes care of the rich—soaks the rich—that that is where it ought to be? Is that, politically, what some people think?

Mr. TURE. We have obviously heard that many times in the past.

I, at one time or another, have been at pains to try to point out that if that, indeed, is the objective, it is likely to fail, because it ignores what the response of either the rich or the poor is likely to be to this kind of a tax. If you assume that rich people are rich because they own more capital instruments than people who are not rich, and use them more effectively and are going to have the same impetus for acquiring and owning capital instruments whether the tax on the return thereto gets higher, and higher, and higher, then you have some very fanciful, noneconomic men and women in mind. I don't think they exist. When you take account of their behavioral responses, you know that with a highly graduated tax, which will fall primarily at the upper regions on the return to capital, the net result is that you will have less capital than you otherwise would have. And with less capital than you otherwise would have, the productivity of labor will be less than it otherwise would have been, and the real wage rate of labor would be less than it otherwise would have been. And where do you come out? That progressive tax, really, has been borne primarily by the nonrich, not necessarily the rich.

Senator JEPSEN. Well, the proponents of flat taxing would indicate concern for charitable deductions, too; they'd take away these high tax brackets and people aren't going to give.

What have you found in regard to that, Mr. Hall, or Mr. Rabushka; or have you already covered that when I was not here?

Mr. HALL. Senator Jepsen, could we answer your earlier question first?

Senator JEPSEN. Progressivity?

Mr. HALL. On progressivity.

Senator JEPSEN. Please.

Mr. HALL. I have no problems saying what a progressive tax is. And if you look at Mr. Minarik's testimony, the section on the Harris survey, the Harris survey had a clear idea of what progressivity was. They say higher income people not only have to pay more taxes but must pay a greater percentage of their income in taxes. And I think it is fair to say that almost everybody would accept that as a definition of progressivity.

I'm sorry that my colleagues here have been not straightforward in asserting what is obvious; namely, that that is what progressivity means.

I favor progressivity. I would not support a tax unless it were progressive. But the key point I want to make is simply that paying a rising fraction of income in taxes does not require a rise in marginal rate. It simply requires that there be a system by which the poor are excused of the tax. That is the type of progressivity that we have proposed, and it is perfectly harmonious with the other principle that is important, namely having the same marginal tax rate for all income.

The evidence from the Harris survey that shows that the American public strongly supports progressivity I find very supportive of the type of proposal that we have made. And it seems to me that we want a progressive system. We have a progressive system today, and we should replace it with a better progressive system.

Mr. RABUSHKA. Can I turn to your charitable questions at this point?

There is, so far as I can tell from the numbers we've seen—and we're trying to get more accurate numbers—somewhere in the neighborhood of about $60 billion a year in contributions which are made to churches, universities, and the like. And from the latest survey of income tax returns, just under $20 billion of this was declared; which means that $2 out of every $3 given in charitable contributions does not imply tax benefits or it comes from after-tax income. So, that is the first point. The bulk of our charitable giving, in fact, does not take advantage of the tax deductability of the contribution.

Then, of the $20 billion we would have to try to estimate how much of that is owing purely to the tax deductibility and how much of it derives from the merit of the contribution. And I think an extremely liberal estimate that would give the benefit of the doubt to the tax deductibility maybe could go as high as $10 billion. So, we are left, at most, with $1 in $6 is at risk. But because we are going to drop from a system of rising marginal rates to a low flat marginal rate, I would be willing to forecast that over a period of time. if real incomes rose, we'd find even more giving, perhaps more than sufficient to offset the reduction totally, as a result of the tax break.

But I want to add one more, final, point, which is that we are in a situation in which we raise this question without asking the prior question, how much of the giving arose in the first place purely as a result of high marginal tax rates rather than as a merit worthiness of the contribution. If a cultural, or intellectual, or social organization came into being only because it was the beneficiary of a tax system which restored the economic behavior, we ought to wonder whether it's necessary to maintain socially that particular institution when we go to a tax system with fewer distortions and which is more neutral.

Mr. TURE. Senator Jepsen, may I comment on your question?

I think that you have mistaken the thrust of the analysis. It isn't—there's no question about whether people give only because of the deductibility. What is at issue is simply the following fact: by virtue of deductibility at graduated rates, the higher the graduated rate the less the cost of the giving. Now, if you say that people have a zero elasticity with respect to the cost of giving, then I think you mistake reality. Elasticity may not be extraordinarily high, but I am confident it is not zero; and you, therefore, should assume that there will, indeed, be some reduction in giving if any flat rate tax is adopted.

I think what, really, is at issue is should this tip of the tail wag the dog? There are far more fundamental issues at stake, it seems to me,

in consideration of flat rate tax proposals whatever they may be than their impact on charitable giving; not to say that that should be ignored, but that it is only one of a very large number of considerations.

Senator JEPSEN. There are a number of subjects here on home builders, nature of buying, government buying, charitable giving—those things all, I think, should be addressed.

And I think, Mr. Rabushka, from your comments, you indicate that if a person was giving because of his tax saving—maybe, to be a little facetious here, we'd say those who want to give to charity, or to the opera, and he can manage those both being in the 70 percent tax bracket because they get a much better deal and he can deduct it.

Mr. RABUSHKA. You know, if one wanted to promote giving as a matter of social policy, the correct way to do it would be to steeply raise the marginal rates back up to 60, 70, 80, or 90 percent and then, I'm sure, we'd have a lot more declared giving.

Senator JEPSEN. Do you really mean that?

Mr. RABUSHKA. No, no. Of course not. I'm trying to ridicule the notion that we ought to say that a particular activity which receives a contribution is valuable because it might lose a contribution if we drop them for a high marginal rate to a low marginal rate. I don't want to leap too far back in the last century, but we had some tremendous philanthropic giving in an era when there was no deductibility at all; so that one gave solely because one wanted to give money away. And we've had that great tradition in this country for a long period of time; giving didn't begin with steeply progressive rates, and it is not going to end. The only question is whether or not this is going to severely impact on some very important worthwhile activities. And my best guess is it won't do any significant damage, and in the end it may be that the more responsive economy to a better tax system, in the median term and in the long run, will find the total amount of giving actually increasing.

Senator JEPSEN. Senator Quayle, do you wish to comment?

Senator QUAYLE. Thank you, Senator Jepsen.

First of all, I don't want to make an oral statement, but I do have a prepared statement for the record.

Senator JEPSEN. The prepared statement of Senator Quayle will be entered into the record at this point.

[The prepared statement of Hon. Dan Quayle follows:]

Prepared Statement of Senator Quayle

I am delighted to be here today, to join with the Joint Economic Committee in its hearings on the flat-rate tax.

Millions of Americans are today fed up with the complexity of our income tax code. Every year complaints proliferate about the difficulty of preparing the individual tax return. Taxpayer compliance is declining while the underground economy is growing rapidly.

I believe we must restructure the tax code to eliminate its complexity and restore its credibility. The flat-rate tax is one proposal designed to achieve these objectives. I have myself introduced in the Senate the SELF-tax Plan Act of 1982 (S.2557), a moderately progressive low-rate individual tax coupled with a flat-rate business tax.

I believe the time has come to seriously consider restructuring our federal tax system. The American people demand it and our economic health requires it.

Failures of the Current Tax System

Henry Simons, writing in his classic study, Personal Income Taxation, insisted that an income tax, if it was to be an improvement over payroll or excise taxes,

> "should be progressive, it should be levied according to simple general rules or principles. . .and it should be as equitable as possible among individuals. Thus, it must proceed from a clear and workable conception of personal income; and it must be constructed in such manner as to minimize the possibilities, both of lawful avoidance. . .and of successful evasion through false declaration."

Our current tax system retains an officially progressive rate structure, but in every other respect fails to meet the primary requirements of a fair tax system. These requirements are: Simplicity, Efficiency, Low tax rates and Fairness (SELF). Our tax system, taking into account all the exceptions and preferences built into the law, is also not even very progressive.

A. Simplicity

A "simple" tax system is one in which the tax code is relatively simple to understand and administer. Regulations, forms and instructions should be easily understood by taxpayers and tax administrators alike.

Today, our tax structure is more complex than it has ever been. In 1954, only 18 percent of taxpayers used tax return preparers; over 80 percent filled out their tax forms personally. In 1981, 52.4% of all 1040 forms were prepared by specialists as were 16.9% of all 1040A forms -- an average of almost 40% overall.

In addition, in 1953, even though most Americans filled out their own tax forms, only 3.2 percent of 1040 and 1040A returns had mathematical errors. In 1976, 8.8 percent of these forms had such errors, and in 1980 the error rate was 7.4 percent.

The Commissioner of Internal Revenue, in 1977, summarized the difficulty clearly when he stated that the basic filing requirements for U.S. tax returns are "beyond the comprehension of a large portion of the adult population."

B. Efficiency

An efficient tax system is "neutral:" it allows personal and business decisions to be made on the basis of their perceived

value, apart from tax considerations. It does not induce individuals and businesses to engage in uneconomic activity in order that they receive specific tax breaks.

Clearly the U.S. tax system has been a major factor influencing recent U.S. patterns in trade, investment, research and development. The tax structure has promoted consumption and over-investment in such items as residential housing and race horses, while it has discouraged business modernization. It has been a major factor contributing to our recent decline in productivity growth.

An efficient tax system is also one which can collect necessary revenues with relatively simple enforcement procedures, made possible by public support and cooperation. Thus, an efficient tax system must be perceived as basically fair and worthy of support.

There was a time when Americans were proud to pay their income tax. Efficiency of collection surpassed the efforts of most other nations, with relatively few tax collectors and special enforcement mechanisms. Today, this situation is dramatically different.

More Americans each year are taking advantage of the available tax loopholes. For every year since 1976 a smaller percentage of American tax returns have chosen to take the standard deduction while a higher percentage has chosen to itemize. Also, the average American taxpayer who itemizes no longer fills out his own tax form; a clear majority of those who itemize have their returns

filled out by professionals. American business also has taken advantage of the tax preferences; it is now estimated that nearly half of all American businesses, as a result of the complex collection of available business tax provisions, will pay no corporate income tax in FY83.

Enforcement of the tax laws has become extremely costly to government. Nearly half of all government-created paperwork stems from different tax forms, requiring an estimated expenditure of 650 billion man-hours annually. The system, rather than inducing cooperation, has angered the average taxpayer who is beginning to turn away from the system altogether. It is now estimated that 15 percent of income goes unreported, probably the highest percentage in the history of the Internal Revenue Code.

Last week the Senate adopted provisions that would reform the tax compliance system. Senator Dole estimates that the income tax compliance gap for both individual and corporate income taxes (the difference between what the Federal Government is owed and what it collects) grew from $21 billion in 1973 to $76 billion in 1981. The Senate bill would require stiffer reporting, higher penalties for noncompliance, and a beefing-up of IRS resources.

The regulatory cost of the present tax system is staggering. Today IRS regulations contained in Title 26 of the Internal Revenue Code fill some 10,000 pages. The IRS employs more than fifty attorneys who spend 65 percent of their time writing new regulations, generally specifically authorized by Congress. Rather than attempting

to cut down on these regulations, we are now considering expanding and enforcing them more effectively. This can only serve to anger the average taxpayer even more.

C. Low Tax Rates

The profusion of tax preferences in the present code substantially redistributes the federal tax burden and renders it considerably less progressive than the published tax rates. Also, by excluding substantial amounts of income from the tax base, rates imposed on the remainder must be kept high so the necessary amount of revenue can be raised.

For example, in 1961 only 10 percent of U.S. tax returns had a positive marginal tax rate other than 20-22 percent. In that year we had almost a flat, rather than progressive schedule of tax rates. Today, in comparison, published tax rate schedules are much more progressive than they were in 1961, but we also have enacted a profusion of tax expenditures.

The result has been, in spite of all the changes in the tax laws over the last thirty years, average tax rates as a percent of personal income have gradually increased, despite passage of the 1964 and 1981 tax laws which both substantially lowered maximum tax rates (from 91% to 70% in 1964; from 70% to 50% in 1981). Between 1951 and 1981 the average tax rate as a percentage of personal income increased from 9.2 percent in 1951 to 12.1 percent in 1981.

D. Fairness

A tax system is fair if it is based on the basic principle of ability of pay. All income should be treated equally as part

of the tax base, and people with the same income should pay the same tax.

Clearly this does not describe the current American tax system. In 1982, U.S. individual income tax rates range from zero to 50 percent. However, U.S. law also provides for well over a hundred separate exclusions, exemptions, deductions, preferential tax rates, credits and tax deferrals which allow for relief or exemption from current taxes. These so-called "tax expenditures" either reduce taxable income or reduce taxes by applying lower rates, credits or delays in tax payment. The total revenue lost to all tax expenditures will be over $250 billion in FY82, well over twice the size of the federal budget deficit projected for that year.

Because of the complexity in the tax law, substantial equity has been lost; different taxpayers with roughly the same income pay far different rates of tax depending on their eligibility for different tax preferences. Tax expenditures have rendered the otherwise progressive rate structure less progressive, partly because tax preferences are most prevalently used by wealthy taxpayers to reduce their tax burden: these are the taxpayers who can afford to hire specialists to take advantage of the tax code's complexity.

A New Approach to Raising Revenues: The SELF-Tax Plan

I believe we need to reexamine the fundamental structure of our tax system. We must reestablish SELF as the overriding principle in taxation: Simplicity, Efficiency, Low tax rates, and Fairness. These principles entail the following:

- People should be able to understand the basic requirements of the tax law and to file their returns by themselves, without the need for professional assistance.
- All income should be taxed equally. People who earn the same income should pay the same tax.
- The poor should not be taxed at all, and we should be careful to establish this standard fairly generously.
- Specific preferences and subsidies should be removed from the tax code; economic policy should be addressed directly and not through incomprehensible tax manipulations.

What I am advocating is a return to a simple, mildly progressive, but low-rate tax schedule. While a single flat rate would be simplest to administer, for reasons of equity I would advocate retaining at least some progressivity in the tax structure. I would exempt from all taxes persons earning $17,500 per year or less. However, I would include all sources of income in computation of each individual's tax-base.

My plan will eliminate almost all special tax exemptions from the code. Government benefits would be counted as income. This would include, for example, unemployment insurance, employers'

contributions to health benefits, credits for child care expenses, the exclusion of employee meals, food stamp benefits, and basic retirement benefits. I would include a provision to ensure that persons receiving Social Security should not be taxed twice on their Social Security contribution.

Currently the officially defined poverty level is about $9,000 per year for a family of four. The value of transfer payments received for the same size family is now estimated to equal about $5,000 per year. I believe that with a $17,500 limitation per individual taxpayer, no poor person by current definitions would be required to pay any tax. In addition, the lowest income recipients among the non-poor population would also be exempt from individual income taxation.

In addition, I believe the wealthiest taxpayers should pay a somewhat higher rate than the average taxpayer. Thus, I would advocate a top rate of 25 percent on incomes above $50,000 per year. Incomes between $17,500 and $50,000 would be taxed at an 18 percent rate. This would add an element of progressivity to the system and should provide sufficient revenue to conduct the activities of the Federal government.

I would permit a dependents' allowance of $600 per person to recognize the costs of raising children. I would retain the current system which distinguishes single individuals from married persons, and I would permit the filing by married couples of joint tax returns.

With respect to business taxes, I would establish a flat 20 percent rate that would apply to all forms of business, including corporations, partnerships, and farms. Business would be taxed on the base of gross earnings, less the amount paid for goods, services and employee compensation. I would permit a capital recovery allowance to encourage investment in plant and equipment and allow deductions for such normal costs of business as interest and depreciation.

As with the individual income tax base, I would repeal the current morass of deductions from the numerous specific business subsidies in the present tax code. Businesses would not be taxed on earnings received from ownership of other businesses, provided the owned business files its own tax return.

I would tax business income only once, with the business tax. I would therefore not tax individuals for earnings from dividends, interest and capital gains, since this income would already have been taxed via the business tax. The effect of removing the current double taxation of business income should be to encourage investment in productive enterprise and to simplify investment decisions.

Under this general plan, then, all official tax rates would be reduced substantially. The top individual tax rate would drop from 50 percent to 25 percent. The top business tax rate would be reduced from 46 percent to 20 percent.

Table I

INCOME TAX REVENUES COLLECTED BY THE FEDERAL GOVERNMENT

FOR FY '82 -- 1981 TAX LAW COMPARED TO QUAYLE SELF-TAX PLAN

	1981 TAX LAW (1982 Estimate)		QUAYLE SELF-TAX PLAN[1]	
	Billions of Dollars	% of Total Fed. Revenue Collected	Billions of Dollars	% of Total Fed. Rev. Collected
A. Individual Income Taxes (per year)	$300.0	47.8	$267.0	40.7
Taxpayers:				
Under $17,500	34.5	5.5	0	0
$17,500-$50,000	198.3	31.6	182.0[2]	27.7
Over $50,000	67.2	10.7	85.0	13.0
B. Business Income Tax	50.0	8.0	112.0	17.1
TOTAL	$350.0	55.8	$379.0	57.8

Source: U.S. Department of the Treasury Office of Tax Analysis, reported in A Program for Economic Recovery, White House report, (Feb. 1981).

[1]Assumes revenues collected from other than income taxes will not be changed (social insurance, excise, estate and gift taxes, custom duties, and miscellaneous receipts) - a total of $277.1 billion.

[2]The $600 dependents allowance (an estimated revenue loss of $6 billion) is attributed entirely to the $17,500 - $50,000 income bracket.

The IRS could devise a post-card on which every taxpayer could compute his own tax. Paperwork for business would be cut very radically, as it would for government. Lower rates would be made possible by a fairly broad expansion of the tax base. The poorest individuals would pay no tax, and we would retain a slightly progressive rate schedule. In addition, business would pay its fair share of the tax burden.

The estimated effects of my proposed plan are summarized in Table I.

As can be seen from the Table (which is based on data produced by the Treasury Department in 1981), if my plan were in effect for the current fiscal year, the Federal government would collect about $29 billion more in revenue than under current law.

The different income groups would be affected differently by the proposed system. The poor and near-poor would pay no tax. In 1982, this group paid $34.5 billion in Federal Income Taxes.

The middle group ($17,500-$50,000) would pay about $16.3 billion less in tax than they pay under current law, providing a somewhat lower percentage of total Federal taxes collected. The $17,500-$50,000 income group would provide 27.7% of total Federal revenues compared to 31.6% under current law.

The wealthiest group of taxpayers (over $50,000 per year) would pay $17.8 billion more in individual income taxes under the SELF plan than under current law. The highest income group would also provide a higher proportion of Federal revenues collected than they do now (13 percent compared to 10.7 percent).

Under my proposed SELF plan, business income taxes would provide $62 billion more in Federal tax revenues than at present. Business would provide 17.1 percent of total Federal revenues - not a high proportion by historic standards. This would reverse the recent trend of eliminating business taxes. In 1982, business income taxes will provide only 8.0% of total Federal revenues. It should be noted, however, that while revenues from direct business income taxes would be increased under the SELF plan, capital gains and interest income would be taxed only at the business and not the individual level. There would therefore be a compensatory reduction in tax burden to individuals with business interests compared to present law.

Necessity for Dealing with the Tax Problem Now

The present tax structure, including its numerous preferences and loopholes, is no longer able to raise sufficient revenues for the operation of the Federal government. If we do nothing to raise revenues we cannot avoid large budget deficits. Such deficits frighten businessmen and investors, causing interest rates to remain very high. This weakens the prospects for a healthy economic recovery. It is clear that Congress must address the issue of long-term revenues if the Federal deficit is to be reduced.

The need to simplify the tax structure is widely recognized. Several bills in addition to my own have already been introduced in both the Senate and the House which would order the Treasury Secretary to propose legislation or to draft changes in regulations to provide for massive simplification of the tax code.

If a serious approach to increasing the tax base is not soon adopted, we will face the prospect of either raising rates or adding new taxes. I believe we will all be better off if we took the path of reform. If we do not, we will be perpetuating the present inequities and inefficiencies in the system.

Many advantages would ensue from a program of tax simplification. Americans could once again compute their own taxes. They no longer would have to employ tax preparers to wade through a jungle of incomprehensible regulations. The ease of dealing with the tax system should result in an increase in income reported, and the underground economy would begin to shrink.

With a low-rate simplified tax structure Americans would have substantially increased incentives to work and be productive. This is because most members of the labor force would be able to keep a much larger share of any additional earnings than under current law. At the lowest income levels, the incentives to earn would be greatly increased since income would not be taxed at all below the $17,500 level. Also, with low marginal rates for the middle and higher income groups there would be little need for tax shelters. Productive behavior would become rational and efficient from both the individual and business viewpoints. The recent decline in rates of national productivity growth might well be reversed.

The system would also be much fairer. People with the same income would pay the same level of tax. There would be no reward to employing high priced tax specialists to gain special benefits by

manipulating confusing rules and regulations; there would be relatively few regulations to manipulate. Everyone who pays tax would do so on the same, straightforward basis. This should reduce taxpayer anger and restore basic public respect for the total system.

The system would also be more equitable and more efficient. The poor would not pay anything, the wealthy would pay a higher rate than anyone else, and business would pay its fair share. A substantial burden in paperwork would be lifted from business, government and individuals alike. Tax considerations would no longer be the driving force behind specific business decisions; the economy would be freer to respond to normal market forces. The result should be higher economic growth and productivity. Overall long-term benefits from such tax reform can be very great, and I believe we should begin to consider the issue seriously.

Senator QUAYLE. I would just like to pick up on this progressivity issue, to pick up on what Mr. Hall suggested, a really progressive tax in nature. I wonder, is there really any flat tax rate that doesn't have some progressivity involved, that has been proposed in Congress?

I would imagine I have read them all, but I—even as straightforward as yours is, 19 percent, but as you get into the deductions, particularly the standard deduction, there is some element of progressivity. So, what we're really talking about is that with a flat tax rate, there is going to be an element of progressivity.

I suppose the political debate that is going to be going on up here is, how far is that element going to go? Under my proposal we have basically three levels; it goes up to as high as 25 percent marginal rates. I think it would do a world of good if we would be able to reduce the marginal rates from 50 percent to 25 percent.

As far as an increase of progressivity, everybody is concerned about this issue of progressivity we have with us. It is going to be incorporated in a flat tax, it is going to be incorporated into a simplified tax, and there is no way we are really going to get around the element of progressivity; so, we're really, you know, beating a dead horse.

Am I correct or wrong?

Mr. RABUSHKA. Can I comment?

Earlier on I was referring to examples in other countries which have single marginal rates, and every one of them, to my knowledge, does have a personal allowance whether in contemporary or historical perspective. So, there's never been a pure flat tax without some personal allowance that introduces this element of progressivity. You're quite right.

Mr. TURE. With the exception of tithing.

Senator QUAYLE. Of what?

Mr. TURE. Tithing.

Senator QUAYLE. With the exception of tithing?

Mr. TURE. I don't recall, in the Old Testament, the Lord said, "Everybody will tithe except" [laughter]——

Senator QUAYLE. But there hasn't been any tithing bill introduced in the Congress, has there? [Laughter.] I don't believe so.

We might conclude that we should get this progressivity issue behind us. We are going to have it; it's just a matter of degree.

I'd like to break this discussion down on personal income tax versus the business side.

Under the simplified tax proposals that have been put forth, whether it is yours or others, are not revenues basically going to be increased from the corporate side of the ledger; is that an accurate statement?

Mr. HALL. It is certainly quite correct to say that the revenue from what we call the business tax would be far above the revenue from the corporate income tax today. That's no doubt. But remember, the business sector is quite a bit larger than the corporate sector, including all self-employed professionals, for example.

Mr. TURE. I'm sorry, but I don't think the statement ought to go out without a lot of qualifications.

As I recall your proposal, you allowed business entities to expense at least capital outlays for new capital instruments?

Again, depending upon what the behavioral response would be, you might very well have, for some considerable time in the future, a virtually zero, indeed very large, legative tax base on business.

Senator QUAYLE. Do you agree with that, Mr. Hall?

I was somewhat under the impression that if you would lower the corporate tax form, say, 46 percent, including surtax there, to 19 percent or 20 percent, and allow normal business expenses to be deducted—let's say reasonable interpretation of business expenses—I was somewhat under the impression that corporate tax revenues would increase, the revenues to the Treasury would increase, and increase to perhaps the amount of the present contributions, about 7 percent, I believe or the revenue to perhaps about 15 or 16 percent of the income. And this is a point that some of the economic projections and data that I have seen would indicate. I just wanted to try to verify that and then get into what you are really talking about as the business side of this simplified tax approach.

Mr. HALL. Let me direct your attention to our joint prepared statement. The numbers are given there for 1981, fiscal year data.

Taxable business income, under the definition that we would use in that table, was $701 billion. Investment that qualified for the official writeup was $349 billion. So you see, first of all, that it would require an extraordinary investment; actually, that I think it would be fair to say it would be inconceivable for business income to be driven down to zero as a result of a behavioral response. There's really a lot of business income.

This is really an important feature of our proposal which would remain even if there was an investment boom; and, of course, we would welcome an investment boom. That would not present any problems. You can see that in the revenue from the business tax. A rate of 19 percent would be $133 billion. The actual corporate income tax, somewhat under the effect of the ERTA for 1981, was $57 billion. There is between two and three times as much revenue from a business tax as there is from the corporate income tax. The corporate income tax has become an instrument largely for redistributing income. That is especially true after the ERTA; appropriate income tax is basically transferring money from the hard corporate productive activities which are taxed very heavily at the 46 percent rate and is used to subsidize other types of activities which are eligible for very heavy interest deductions. The revenue from corporate income taxes, as a result, is dribbling away almost constantly.

But that is not a healthy sign. Concealed within that are very heavy positive tax rates on many—most—productive activities, bringing the whole business sector interest, the whole principle of corporate taxation, we'll say, from the start. We have business taxation, not corporate taxation. There should be no distortion one way or the other between corporate and noncorporate organization of businesses. We would bring all businesses in under the same tax and use that tax instrument as a way of enforcing the principle that all income should be taxed exactly once. Doing so gives rise to new revenue income, a business tax substantially above what comes currently from corporate income tax and would remain above under any conceivable further development of the American economy.

Senator QUAYLE. This total actual revenue, tax revenue, $348 billion, is that what we get now?

Mr. HALL. Yes. That's the calendar 1981 yield from the personal and corporate income tax.

Senator QUAYLE. What figure would you suggest?
Mr. HALL. $346 billion.
Senator QUAYLE. That's under your proposal, would be $346 billion?
Mr. HALL. Right.
Senator QUAYLE. So, that wouldn't be a change.
Mr. HALL. That is right.
Remember, that 1981 is a very different year from 1982 and future years, because the large personal tax reductions had not gone into effect in 1981, calendar 1981.
Senator QUAYLE. Aren't we talking about the corporate income tax here?
Mr. HALL. Well, no. The $346 billion and $348 billion are revenue from the two taxes.
Senator QUAYLE. This is both.
Mr. HALL. Yes.
Senator QUAYLE. Could we compare what these numbers are from the revenue from the corporation under your proposal and what we have now?
Mr. HALL. Well, we don't tax the corporations any differently from the business tax. The revenue from the business tax is $133 billion.
Senator QUAYLE. All right. Wait a second. You have it explained here—$133 billion to $57 billion.
Mr. HALL. Pardon me.
Senator QUAYLE. The difference would be that right now, under your proposal, you are estimating raising corporate revenue at $133 billion, and the actual corporate income tax is right now $57 billion.
Mr. HALL. Correct.
Mr. RABUSHKA. Except it's not just corporate tax. That's why the number is so much higher. All business, really.
Senator QUAYLE. All business.
That means partnerships, and so forth.
Mr. RABUSHKA. Self-employed, architects, and so forth.
Senator QUAYLE. Business. OK.
Mr. HALL. All kinds of businesses.
Senator QUAYLE. Other than individuals.
Mr. RABUSHKA. Other than labor income.
Senator QUAYLE. Other than labor income.
Senator JEPSEN. Everyone that doesn't have a 1099 file?
Mr. HALL. Certainly, anything that comes under 1099 would be treated as business income.
Senator QUAYLE. This comes out to what, $76 billion increase in revenue or tax to the business sector under your proposal?
Mr. HALL. No. Because we have them broken out separately. A large amount of personal income tax is paid on business income.
Senator QUAYLE. The what?
Mr. HALL. The taxation of business income, under the current tax system, is split between the corporate income tax, and schedule C, and other provisions for taxing business income under personal income taxes.
Mr. TURE. Senator Quayle.
Senator QUAYLE. Yes.
Mr. TURE. I am not familiar with the details of the calculation that the gentlemen have made; but just looking at it, it strikes me that they

have not gone about it right. What they should have done was to have taken the GNP originating in the business sector—not gross national product, which includes, I regret to say, a not insignificant amount of GNP originating in the Government, and originating abroad as well. So, what you want to do is start with GNP originating in the business sector and take out the deductible cost therefrom. I don't know whether the numbers would come out larger or smaller; but in any event, that, I think——

Mr. HALL. No.

Mr. TURE. All you have is wages and salaries of government employees in here?

Mr. HALL. Certainly. I think we should review it separately.

Mr. TURE. Sure.

Mr. HALL. Let us just be clear, that the way this tax system works is that we do propose a personal compensation tax on all government employees.

Mr. TURE. That is not the point. The point is you are deducting wages, salaries, and pensions, not just of business entities but of government entities in order to find what you deem to be the business taxable income.

Mr. HALL. The way the national income is constructed is that the only gross national product contribution that comes from government is the payment of wages and salaries. We have done it correctly. And what is left in national income accounts, there is no business type income associated with government. The government is only wages and salary.

Mr. TURE. That is precisely the point.

Senator QUAYLE. I suppose this is one reason for having these hearings, but I am struck by the political alliance that is beginning to emerge on the tax simplification issue. On one side you have those people that have been professing to have lower marginal rates, lower overall tax rates, as a way to increase the productivity and the way to see the GNP expand. On the other side you have a number of people who are now going for tax simplification who see that this is a way to get at so-called business deductions and tax expenditures, or however else you want to identify that.

Furthermore, we have seen the erosion of the revenue base in the corporate income tax from about 16 percent—15 percent—on the average basis down to, oh, 6 or 7 percent. As a matter of fact, by 1984–85, I estimate top businesses and industries will be paying effectively no corporate income tax. As a matter of fact, one of the responses in the last tax bill was to modify the Safe Harbor Leasing Provision that would, in a way, allow a number of businesses, even profitable businesses, to escape an income tax, paying of the corporate income tax. So, you've got a rather phenomenal political situation that has emerged here, one that gives a great deal more credibility to this proposal than it has had in the past, even though it is not necessarily a new idea, because of the complexity in the way the tax code has gone. That is why I think it is necessary for use to explore a flat tax, particularly on business. To my personal knowledge, it is going to be far more difficult to enact a flat tax on a simplified tax on the business side of the ledger than it would be on the individual. I think, on the individual side, that obviously the progressivity elements are

going to be with us, obvious from political reasons, whether they would be economically explained or not. You're going to have to take into account not only charitable contributions but mortgage deductions, maybe municipal bonds. Four, five, or maybe even six major elements of that are going to have to be included.

How are you going to treat banks under this proposal? Are they going to be treated any differently than other corporations, in your opinion; or are they going to be treated the same way?

Are you just going to eliminate all the tax laws that we have for the banks and just apply the 19 percent to them? What is your response to that?

Mr. HALL. They fit exactly into the principles here, provided that you propose a rule that would apply not just to banks but to all businesses; namely, that they would not be allowed to net the money that they are paying out to the holders of securities as deposits, in the case of the children in the school. And the return to the security is free services.

A good example of abuse of the tax system that is possible today is that you set up a private school and then sell a security to parents of the children in the school. And the return to the security is free training in the school. That is the kind of abuse of the tax which is, in principle, illegal today, although it does occur in some areas. Banks do it today. Again, it is abuse of the current tax system.

We would favor a set of rules under which that abuse would not be permitted anywhere. With that one exception, then, banks are treated exactly the way that all businesses are. It's the exact same form. It's just that the top line of their business tax return has to be the gross receipts that they've obtained from their customers by way of all service charges not netted against the payments they make. Otherwise, banks fit in perfectly.

Mr. TURE. May I make a followup comment?

I find a number of things that are troublesome in the Hall-Rabushka proposal as well as things that are intriguing. But surely the single most troublesome aspect of it is the terrible retrogressing.

These had developed, I was delighted to see, a consensus, a growing consensus, among tax economists of all stripes that the business entity is not the appropriate subject of taxation. We do not—we should not—properly tax the corporation. The corporation does not pay a tax. The corporation is not a real live human being; and it is the suppliers of the productive services, who receive incomes for those supplies, who ought to bear tax liability.

Now, it may very well be that they will want to treat their tax as a withholding device; but if so, it is a mighty inept withholding device. And the way they ought to go, it seems to me, to improve and improve very materially on that proposal, by devising some way to attribute all of the income by entities like corporations or tax-exempt organizations, if that's the way they want to go, to the people who have an ownership interest. And that, I think, would be an essential precondition.

Mr. HALL. Senator, may I comment on that?

Senator QUAYLE. Surely.

Mr. HALL. There seems to be a misunderstanding here. Because we would regard our tax system as precisely what Mr. Ture has just

suggested; namely, that fundamentally, the thing to be taxed under any good tax system is consumption—or expenditures we called it earlier—and that is exactly what our tax system is. We have figured out a way to administer a consumption tax in which, instead of having to actually go through the motions of attributing all of the income down to the owners of the businesses, we already know the tax rate that the owners will be paying is 19 percent. Remember, we can collect that tax mechanically on the level of the business.

There is no suggestion whatsoever that we have retrogressed from the principle that, fundamentally, is that people be taxed. We have simply figured out an administrative way to collect the tax in a way that is feasible. The principle of trying to capture business income at the level of individuals has failed in the current tax system. Large amounts of interest, dividend income, is simply not reported. A shocking fact in the personal income tax, for example, is that interest deductions exceed interest reported as income. And yet, we know that the public receives much more interest than it pays out. The tax system has failed in that respect.

It is unnecessary and totally undesirable, under a consumption tax of our type, to attribute and actually require that individuals file returns under business income. We could do that on the business level. That is an administrative issue, not violation of a basic principle that I certainly subscribe to, that people pay taxes and that we should regard businesses as people that are sometimes taxed because they are people. That mentality gave us the corporate income tax, which is a ghastly mistake. But, on the other hand, I took it to be reasonably well accepted among tax economists that one can administer a consumption type tax—at the level of business.

Senator QUAYLE. Do you agree with that?

Mr. TURE. No; I think there is obviously not much truth in what Mr. Hall is saying. I think there are many exceptions to be taken.

I think the whole cast of your discussion, the whole cast of your proposal, identifies this more and more as a business tax. And, indeed, the final, ultimate test is with any kind of exemption or zero-rate bracket, you are, nevertheless, going to impose a tax on people who might not—people who might not—be taxable were the business income realized by them. And you make no provision for an exemption system, so your tax really is not just a device for withholding; in fact, what you have got is sort of weaving through the national income accounts to say that we tax in such and so a way. But the accounting will show that the ultimate base of the tax is the amount spent for consumption. That is quite a lot different from imposing the tax in such a way on people that they perceive that there is equality in the cost of their using their resources for this versus that purpose.

Senator QUAYLE. Mr. Minarik, can you shed any light on this? Do you have any numbers where the flat rate tax might go as far as the distribution of revenue from the corporate side to the individual?

Mr. MINARIK. Quite honestly, Senator, I wanted to try to figure out a number. I'm afraid that in the rush of things I did not, on the way over here. Messrs. Hall and Rabushka are correct that there is a distinction between the accounting we have under the current tax and the accounting they have, because the business sector is not the corporate sector. The business sector includes corporations and it also includes

the unincorporated businesses, sole proprietorships, partnerships, subchapter-S corporations, and such. So, one cannot directly compare those two revenue numbers.

Mr. Ture is correct that the Hall-Rabushka proposal achieves a great deal of simplification in terms of reporting of business income; but, on the other hand, it doesn't exempt low income recipients of business income from tax. If you wanted to exempt the elderly retiree who gets $5,000 worth of dividends from paying tax on that $5,000, you would have to have an information form from the corporation that would go to the Internal Revenue Service to be matched with that individual's tax return. You're trying to get away from that, and that is the one area where a simplification of flat rate tax conflicts with the principle that only people pay taxes. The way their corporate sector works out, it's really only corporations that pay taxes. And the place where that shows up is the absence of the refund of the withholding tax on the dividends.

Senator QUAYLE. Do you have any numbers back at the shop?

I'd appreciate this. I've been trying to pursue this, just to see what this would do to the business side of the ledger. Because the corporate income tax, as I know it, is being reduced dramatically; and I think that is one of the political motivations for a rather broad-base support that is beginning to emerge for tax simplification. I think this needs to be discussed thoroughly.

Mr. MINARIK. I will be happy to try to help you work it out.

[The following letter, together with an attached table, was subsequently supplied for the record:]

CONGRESSIONAL BUDGET OFFICE
U.S. CONGRESS
WASHINGTON, D.C. 20515

Alice M. Rivlin
Director

October 4, 1982

Honorable Dan Quayle
United States Senate
Washington, D. C. 20510

Dear Senator Quayle:

Enclosed is a tabulation in answer to your request during the hearings of the Joint Economic Committee Subcommittee on Monetary and Fiscal Policy on July 27, 1982, considering the flat rate income tax.

Your question was the effect on corporate income tax revenues of the proposal of Professors Robert E. Hall and Alvin Rabushka of the Hoover Institution. I prepared a computation of the tax liability of corporations under their plan, and have cleared the computation with them. The computation is based on actual 1979 corporate incomes and deductions, and is compared to an approximation of corporate liabilities at those levels if the 1984 corporate income tax law were in place.

The enclosed tabulation attempts to show the distinction between the taxes due from the corporate sector, which is treated separately under current law, and the entire business sector, which Hall and Rabushka would treat as one piece. The right-hand column in the table shows the entire business sector, and is therefore equivalent to the Hall and Rabushka testimony, though for 1979 levels of income. The left-hand column shows the corporate sector only. My estimate of the tax due from corporations under the Hall-Rabushka Plan is $11.8 billion (or about 22 percent) higher than it would have been under the 1984 corporate tax law. Note, however, that a substantial part of the tax due from corporations represents the effects of eliminating the corporations' deductions for their payments of nonwage compensation to their empoyees. If the corporations simply paid their employees in cash instead of in noncash benefits, or if they reduced their wage payments to recoup the additional tax (as they almost certainly would), the corporate tax revenues would fall by $19.7 billion, or about 37 percent, below what they would have been under 1984 law.

I hope that this information is useful.

Sincerely,

Joseph J. Minarik
Deputy Assistant Director
Tax Analysis Division

cc: Senator Roger Jepsen

TAX LIABILITIES AT 1979 INCOME LEVELS
HALL-RABUSHKA AND 1984 LAW
(In Billions of 1979 Dollars)

	Hall-Rabushka Corporate	Hall-Rabushka Business
Gross Domestic Product	1,494.9	2,370.1
-Indirect Business Taxes	139.6	188.4
-Wages, Salaries, and Pensions	859.6	1,255.9
-Net Rent	N.A.	11.7
-Investment	153.5	176.8
=Tax Base	342.2	737.3
xTax Rate	.19	.19
=Tax	65.0	140.1
1979 law tax	74.6	N.A.
1984 law tax	53.2	N.A.
Hall-Rabushka tax less 19% of wage supplements (165.6) (225.0)	33.5	97.4

SOURCE: National Income and Product Accounts, 1979.

N.A.: indicates not applicable.

Assumptions: $25.0 billion of pensions paid; 1984 corporate tax cut equal to 40.3 percent of 1979 liability.

Senator QUAYLE. I am not a member of this distinguished committee, but I certainly want to compliment the chairman of this subcommittee for having this hearing and inviting me to be here; also for inviting a rather illustrious panel. Because I think this is really a first test on the simplified flat tax proposal that is going to be around a lot longer. I know the people are going to be putting in proposals. This is the beginning, and I want to congratulate each of the panel members, and, particularly, this subcommittee, as setting a precedent for getting into issues that are of great importance and relevance to what has been going on.

So, with that, I adjourn the meeting.

[Whereupon, at 12:45 p.m., the subcommittee adjourned, subject to the call of the Chair.]

THE FLAT RATE TAX

THURSDAY, AUGUST 19, 1982

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON MONETARY AND FISCAL POLICY
OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:30 a.m., in room 5110, Dirksen Senate Office Building, Hon. Roger W. Jepsen (chairman of the subcommittee) presiding.

Present: Sentors Jepsen and Mattingly; and Representatives Richmond and Hansen.

Also present: Bruce R. Bartlett, deputy director; Richard K. Vedder and Mark R. Policinski, professional staff members.

OPENING STATEMENT OF SENATOR MATTINGLY

Senator MATTINGLY [presiding]. The subcommittee will come to order.

This is the second of a series of hearings of the Subcommittee on Monetary and Fiscal Policy of the Joint Economic Committee on the flat rate tax concept. There is a strong feeling that America's tax system is a mess. As Milton Freidman said in a letter which will be placed in the record of this hearing, "Our present income tax is a monstrosity." It took the Wall Street Journal more than a page just to describe the highlights of the changes in the tax code incorporated in the bill currently before the Congress.

The recent interest in the flat rate tax reflects a growing belief that the current income tax is much too complicated, very unfair, and a deterrent to productive activity necessary to revitalizing America. The Joint Economic Committee is pleased to be taking a leadership role in calling attention to tax alternatives in the hopes that our tax system can be made fairer, simpler, and can help rather than hinder America in its effort to regain its historic role as the world's most prosperous economy.

We are pleased to have with us today four of the country's leading experts on tax problems. Paul Craig Roberts, former Assistant Secretary of the Treasury, has done as much as anyone to renew our neglected interest in the importance of the "supply side" dimension in making economic policy. He has been an articulate advocate of removing incentive-destroying aspects of our tax system. David Bradford of Princeton University directs the business taxation research program of the National Bureau of Economic Research and is a former Deputy Assistant Secretary of the Treasury. In addition to these economists, we have two tax lawyers with extensive adminis-

trative experience. Jerome Kurtz was the Commissioner of Internal Revenue under President Carter, and we will be interested in his views of some of the practical and administrative aspects of changing our tax system. Ernest Christian served as Deputy Assistant Secretary of the Treasury for tax policy in the Ford administration and has a longstanding interest in tax reform.

We have additional inserts for the hearing record, one, a letter, together with an enclosure, from Professor Milton Friedman and the other a statement, together with supplementary remarks from Mr. Jim Jones, the Texas businessman whose gross income tax approach has been a pioneering attempt at rethinking our tax system. We welcome their statements.

[The letter, together with an enclosure, and statement, together with supplementary remarks, follow:]

HOOVER INSTITUTION
ON WAR, REVOLUTION AND PEACE
Stanford, California 94305

August 7, 1982

The Hon. Roger W. Jepsen
Vice Chairman, Joint Economic Committee
United States Congress
H2-359 House Office Building
Washington, D.C. 20515

Dear Senator Jepsen:

Unfortunately I cannot be present in person at your hearings on the flat-rate tax. I appreciate, however, the opportunity to express my views in the form of this letter and the enclosure.

A true flat-rate tax is a tax that is levied at a single rate on everyone on a tax base which equals total income with no deductions except for a personal exemption plus strictly defined expenses of earning the income.

I have long favored such a flat-rate tax. I discussed its merits in my book Capitalism and Freedom published in 1962 and I have repeatedly written in favor of it in Newsweek and elsewhere. I have, however, been skeptical that it would be politically feasible to adopt such a tax.

Your hearings give cause for optimism on that ground and your committee is to be congratulated for holding hearings on this enormously important topic.

The reasons why I favor a flat-rate tax and why I have considered it not feasible politically are contained in a column that I published in the Newsweek of August 2, 1982. I am enclosing a copy of that column. I should appreciate your incorporating it in the record.

Our present income tax is a monstrosity. It is inequitable, imposing very different tax burdens on persons in essentially similar circumstances. It encourages waste and inefficiency by leading millions of our fellow citizens to devote their energies to activities that will avoid taxes rather than to activities that will yield the greatest benefit to their fellowmen. And it is counterproductive, yielding less revenue than would a flat-rate tax at a moderate rate.

The substitution of a flat-rate tax for our present income tax would do more than any other tax reform I can conceive of to promote equity, the effective utilization of resources, and to broaden the opportunities available to people of every income level.

Sincerely yours,

Milton Friedman
Senior Research Fellow

F:v
Enclosure

MILTON FRIEDMAN

How Flat Is Flat?

A recent surge of interest in replacing the present income tax by a flat-rate tax has elicited two predictable reactions: first, the surfacing of the old myth that, in the words of Tom Wicker, "the result [of a flat-rate tax] would be a massive redistribution of income, with more of the tax burden shifted from the rich to the poor and middle class"; second, the use of the rhetoric of flat rates as a disguise.

The Myth: A true flat-rate tax has two components: first, a single tax rate applicable to everyone and to the whole of the tax base; second, a tax base equal to total income with no deductions except personal exemptions and strictly defined expenses of earning the income. If present personal exemptions were retained, a rate of not more than 15 or 16 percent would yield the same revenue as the present system with its rates of 12 to 50 percent. If present personal exemptions were raised substantially—as they should be in view of the extent to which their real value has been eroded by inflation—a somewhat higher rate, perhaps 17 percent, would be required to raise the same revenue.

Contrary to Wicker, the poor, middle class and rich would all gain from the substitution of a true flat-rate tax for the present income tax. The poor would pay less tax because of high personal exemptions. Many in the middle class would pay less tax because of a lower rate. Others in the middle class and the rich would pay more tax to the government yet be better off. They would pay more because the lower rate would render present costly tax shelters unattractive. They would be better off because their gain from being free to use their assets in the most productive instead of the most tax-evasive way would be larger than the extra tax. Tom Wicker's mistake is his failure to recognize how large a wedge there is between the taxes paid and what it costs taxpayers to pay and avoid or evade taxes.

Rhetoric: The flat-rate tax is clearly a splendid idea. However, it also arouses intense opposition from powerful special interests created by the existing tax system: recipients of so-called charitable contributions, homeowners, the housing industry, institutions financing housing construction, the myriad other producers of and beneficiaries from tax shelters, tax lawyers and accountants, and, last but not least, politicians who raise campaign funds from special interests seeking to retain existing tax loopholes or to create new ones.

A constitutional amendment is the only way to get a true flat-rate income tax.

A formidable lobby indeed, which is why I have for decades tempered my enthusiasm for a flat-rate tax with a realistic recognition that it does not have the chance of the proverbial snowball.

Bills labeled "flat rate" have been pouring into the legislative hopper. Some provide for a true flat rate. Most have only the label. They retain major deductions and keep graduated rates. For example, Sen. Bill Bradley and Congressman Richard A. Gephardt have introduced a much-publicized bill for a "flat-rate tax" that would retain deductions for contributions, interest paid on owned homes, state and local taxes and income from social-security and veterans' benefits. It also would have rates running from 14 percent to 28 percent—or a top rate double the bottom rate. A far cry from a true flat rate.

'Left' and 'Right': Nonetheless, such proposals seem extremely attractive. They offer a compromise between the so-called left and right. The left might accept a lower top rate as the price of gaining a broader base. The right might accept a broader base as the price for gaining a lower top rate.

However, appearances are deceiving. Such a compromise is neither desirable nor feasible. Neither side would trust the other and both are right. If it were ever enacted, the left would go to work to raise the rates—and they would quickly be joined by persons on the right pleading fiscal necessity. The right would go to work to broaden the deductions—and they would quickly be joined by persons on the left pleading equity and social priorities. After all, that is how we got into our present fix. History would simply repeat itself.

There is, I believe, only one way to make a bargain stick: by amending the Constitution to require that any income tax must be levied at a flat rate with no deductions from the tax base other than personal exemptions and expenses of earning the income.

We seem to be well on our way to enacting a constitutional amendment to balance the budget and to limit taxes. Perhaps the time has come to take the next step and outlaw the outrageous kind of income tax from which we now suffer.

TESTIMONY SUBMITTED

TO

THE JOINT ECONOMIC COMMITTEE

BY

JIM JONES

Mr. Chairman, I am Jim Jones of Blanco, Texas. I am a semi-retired businessman, the founder and owner of the J.H. Jones Co., which is a warehousing distributor of power transmission equipment with headquarters in Houston.

I also head the Government Research and Development Corporation, a nonprofit organization devoted to public policy research. I founded the organization in 1976, and I call it an "agency of the individual American citizen." I provide the financing for GRDC, which is staffed mostly by volunteers.

For more than seven years, I have vigorously advocated a fundamental revision in the federal income tax system. I have advocated replacing the present system, which is based on net income, with a simplified system based on gross income. This is a business-oriented tax. I call my proposal the Gross Income Tax (GIT).

In recent months, a number of Senators and Representatives, not to mention economists and other experts from the academic community, have come forward with a dazzling array of tax reform proposals. To all these people, I say "Welcome aboard." It's been a very lonely fight out there for the past seven years, and tax reform needs all the friends it can get.

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These many proposed reforms, Mr. Chairman, add fuel to a growing debate about tax reform. I cannot imagine anything more healthy than an informed, robust debate about this subject.

But let me suggest to the Committee that many of the current proposals, well-meaning as their sponsors may be, do little more than change the look of the present system, and do not achieve basic reform at all. Certain proposals would retain a number of the basic flaws of the current system, such as deductions and exemptions above the profit line. The current system is laced with loopholes and special-interest provisions, which lead to a tax system that is inherently unfair and inequitable. Some current proposals would perpetuate these undesirable characteristics.

Still other proposals could be easily converted into plain and simple tax-raising measures. These proposals would do away with some of the current deductions and exemptions, but they would impose a high rate of tax. The result for individuals and business entities would be a high rate of tax applied to an expanded tax base.

All of these considerations cloud the real issues before the Committee and the nation. The issues are these:

- The current systems is so complex that only a handful of experts understand it -- or say they understand it.

- o The present system places a heavy and costly administrative burden on the nation. The Internal Revenue Service (IRS), charged with tax collection, does an honest and generally creditable job, but its task is huge.
- o The present system favors certain taxpayers who have certain kinds of income. The general public views such a system with suspicion, figuring that some people are benefitting at the expense of the average wage earners. The general public is right.

I would like to address just three aspects of this highly complicated issue. First, let me point out the tremendous burden that the present system imposes on us. Next, I want to examine one of the leading tax reform proposals, that put foreward by Professors Robert E. Hall and Alvin Rabushka of the Hoover Institute at Stanford University. Finally, I want to say a word about GIT.

The Present System

The present system of taxation is complex and burdensome on the economy. We all know that, but sometimes we take for granted the large financial cost that the nation incurs in administering the net income tax system.

Considering only the Taxpayer Service activity at the Internal Revenue Service. This is the program that provides toll-free telephone and walk-in assistance to taxpayers, including guiding groups of individuals line-by-line through preparation of their tax returns. It provides individual return preparation for the handicapped or other taxpayers who show an inability to benefit from the group preparation method. The IRS also responds to written taxpayer inquiries, and distributes free of charge an extensive list of publications on tax issues. IRS conducts numerous taxpayer education programs, including a Volunteer Income Tax Assistance (VITA) and Tax counselling for the Elderly. Finally, IRS disseminates tax information through the mass and specialized media -- television, radio, general circulation publications, and trade journals.

All of this activity reached some 44.8 million taxpayers in fiscal year 1981, and the IRS estimates that it will reach about the same number in fiscal year 1982.

This is expensive business. In fiscal year 1982, the Taxpayers Service budget activity totalled $230,530,000.

This program is necessary largely because the present system is so complicated that nobody understands it.

There are other measures of the cost of the present system. For example, the IRS maintains a current inventory of approximately 240 major tax forms, and approximately 180 more forms on miscellaneous tax items. The printing procurement for this printing totals about $28 million a year .

Recently the IRS undertook yet another tax form simplification effort. It employed the firm of Siegal and Gale to attempt the largest single tax form simplification study effort to date. That contract cost the taxpayers $1.9 million. It also produced a simplified Form 1040 accompanied by a 56-page booklet explaining the form.

Then there is the cost of IRS itself. The annual payroll for IRS is projected at $2.16 billion in fiscal year 1983. That will pay for the service of some 88,673 IRS employees. The total IRS budget in fiscal year 1981 was $2.4 billion.

The paperwork burden of the current system is another way to measure its impact. Of the total amount of paperwork generated to meet federal requirements, 41.98 percent was attributed to tax collection requirements in fiscal year 1981. While the IRS expects to achieve a 9 percent reduction for fiscal year 1982, its percentage of the total federal reporting burden will rise slightly, to 43.80 precent of the total, based on OMB estimates.

Hall-Rabushka Differentiated

Much attention has been paid in the past few months to the proposals but forward by Professors Hall and Rabushka. The general thrust of their proposals -- to simplify taxes and achieve a flat rate of taxation -- is commendable. But there are serious flaws in their theory.

First, the Hall-Rabushka plan would continue to tax individual taxpayers in somewhat similar fashion as today, except that it would remove all deductions other than personal exemptions. Thus, it really preserves a tax system that is individual-oriented rather than business-oriented. Under Hall-Rabushka, wage earners would still have to compute their tax owed and file returns.

Second, Hall-Rabushka would continue in large part the present system for computing tax owed by business entities. A business would pay on income, which is defined by Hall-Rabushka as gross income minus the cost of goods, services, and wages. Business would be allowed a one-year writeoff of capital investment, but would be allowed no deductions for depreciation, interest, or payments to owners of capital.

Now all this begins to sound very much like the present system of tax based on net income. Professor Hall and Rabushka are simply giving us more of the same. They stir up the pot, rearrange the potatoes, and come out with pretty much what we have now.

The GIT Program

The crucial underlying flaw of the current system is that it is based on net income. By law, net income means different things to different people. What one taxpayer can deduct, another cannot. Income that is taxable for one taxpayer is sheltered for another. And so on. The tax that one pays depends in large part on ones ingenuity.

The search is underway for a fair, efficient, and workable system that everyone can understand. I submit to the Committee that GIT is such a system. It is based on gross income, by which I mean just what the current Internal Revenue Code says is gross income -- the gross receipts of a business entity, less cost of goods sold.

GIT would eliminate an estimated 90 percent of recordkeeping and internal paperwork for employers, and 95 to 100 percent for employees. Few employees would file income tax returns. GIT would give government a useful management mechanism with which to control the amount of revenue to be collected.

GIT would operate like this: Most individuals would not file an income tax return. Instead, the IRS would collect federal income tax and FICA by taking a percentage off the top of gross receipts of every company and business operating entity. A person earning more than $50,000 per year would be treated as a business operating entity. Companies and business operating entities would file tax returns and pay their taxes on gross income. They also would file returns on essential employee information, and the IRS would allocate the appropriate amount of tax for each employee out of the GIT pot, which would already have been collected by the employer from his business activity.

Congress would set one tax rate for all companies and business operating entities. A respected economist who has studied GIT estimates that rate at between 4½ and 7½ percent, given current budget levels.

Under GIT, Congress would eliminate all deductions, but would allow tax credits for certain items, such as the purchase of a home, a charitable contribution, and so on.

There are many more aspects to the GIT system, which are contained in the supplementary remarks that I am submitting to the Committee.

The important points about GIT are the important points about the entire national debate on tax reform. In short, the nation needs a tax system that:

- o Is simple, so that people can understand it.
- o Is fair, so that the general public supports it.
- o Is inexpensive, so that the nation can afford it.
- o Is equitable, so that all taxpayers pay the same rate.
- o Is based on success, not failure so that successful businesses are rewarded instead of penalized for earning high profits.

GIT does away with deductions and exclusions and loopholes. It taxes income only once -- at the source, which is business activity. It allows successful business to accumulate capital, which is what the country needs.

GIT would accomplish many important goals for the nation. I commend the GIT system to the Committee for its consideration.

Thank you.

SUPPLEMENTARY REMARKS

TAKING THE OUCH OF THE TAX BITE

By Jim Jones

In a recent speech, former Commissioner of Internal Revenue Jerome Kurtz cited statistical evidence from the Department of Health, Education, and Welfare that the basic filing requirements of the Form 1040 (U.S. Individual Income Tax Return) were beyond the comprehension of a large portion of the adult population.(1)

In addition to the 28 pages of instructions that accompanied Form 1040 in 1978, the IRS found it necessary to publish some 92 "self-help" publications to enable taxpayers to fill out their own returns. Most Americans gave up before they started, and had their tax returns filled out by professional tax preparer-spending $500 million to do so.

While many taxpayers quarrel with the amounts the Government extracts and many quarrel with the waste that seems inevitably to accompany Government spending, the real quarrel - the issue that gets taxpayers' backs up - is the staggering burden of dealing with the IRS. To fill out an endless array of tax forms, to maintain ever-growing stacks of yellowing receipts, and otherwise to comply with IRS rules and regulations has, for many, become a year-round activity.

This back-breaking burden - one that weighs as heavily on individual citizens, comparatively speaking, as it does on big business - is not the fault of the IRS. It results from a long history of action by Congress in passing a never-ending stream of tax legislation, the sum of which - the tax "system" - has no rhyme, no reason, no rational basis to it at all. And it is the task of making this "system" work that falls to the hapless IRS, which often finds itself in the frustrating position of clarifying and simplifying its tax forms and instructions at the same time Congress is discussing new and even more complicated tax provisions.

IS ASPIRIN DEDUCTIBLE?

When, on October 31, 1913, President Wilson signed into law the Underwood-Simmons Tariff Act, he set in motion a Federal income tax system that today has become a crazy quilt of short forms, long forms, schedules, deductions, perferences, exemptions, and exclusions that virtually no one can understand. Indeed, in a 1975 address to the Tax Foundation, then Secretary of the Treasury William E. Simon said, "I'm not even sure the IRS experts fully understand the system anymore. How can they when they are dealing with a tax code and regulations that exceed 6,000 pages fo fine print?"(2)

The confusion and complexity of the IRS code is reflected in the forms both individual and business taxpayers must fill out. The Tax Reform Act of 1976, for example, added five new entries to the Form 1040 and eight to the Form 1040A, otherwise known as "the short form."(3) The Office of Management and Budget estimates that the standard individual tax form (Form 1040) takes an average person nearly 3 hours to fill out.(4) This does not include the time needed to

gather information or to keep records throughout the year.

Business taxpayers must spend even more time filling out Federal tax forms. In 1977, businesses spent a total of 109 million manhours filling out employee wage and tax statements (Form W-2) alone. At a minimum, most businesses are also required to file an Employer's Quarterly Federal Tax Return (Form 941) and a statement of Withheld Income and FICA Taxes (Form 501). Further, all incorporated businesses must file a U.S. Corporation Income Tax Return (Form 1120), the corporate equivalent of the Form 1040. Proprietors of unincorporated businesses typically file a Schedule C (Profit or Loss From Business or Profession) along with their personal income tax return (Form 1040).(5)

To fill out all of these forms is, for many businesses, a major expense. For the largest businesses, to fill out Federal tax forms and information returns means the full-time, year-round services of teams of tax lawyers and accountants. In 1976, for example, it cost one large multinational corporation $136,960 to prepare the 18 different Federal tax reports it was required to file. This breaks down to an average cost of $7,609 per report.(6) Small businesses are hit hard, too. The National Federation of Independent Business found that, in 1976, small businesses nation wide spent more than $11 billion to have their Federal tax forms prepared.(7)

OUT OF CONTROL

It is ironic that a good chunk of the Federal tax dollars Americans pay each year goes toward printing the very forms, instructions, and other IRS materials that are too complicated for many to understand. In fiscal 1978, the IRS spent $34 million to print and mail all its tax forms and instructions. It spent another $3 million to print and mail its various self-help publications.

The budget of the IRS ($2.15 billion in fiscal 1979) also goes toward paying the salaries of some 87,000 employees, many of whom staff IRS informaton centers around the country, answering questions from taxpayers year-round. Others are employed to make sure the more than 670 million tax and information returns the IRS receives each year are filled out correctly.

There is no question that the time has come for simplifying the entire Federal tax system. Already it has become a matter for debate whether the Government is serving the people or the people are serving the Government.

How much longer American taxpayers are going to put up with the mishmash of IRS regulations and the inconvenience and expense of complying with Federal tax laws is anyone's guess. But if recent localized outbreaks of taxpayer protest continue, it may not be long before all taxpayers nationwide stand up and shout, "We're not gonna take it anymore."

Efforts to simplify the tax system are not new. Various proposals have sprung up in nearly every session of Congress since the first modern income tax law was passed in 1913. But, for the most part, tax legislation has been aimed at simplifying only particular provisions of the tax law. For example, the income averaging rules were simplified under the Tax Reform Act of 1969 and the Revenue Act of 1971 simplified some aspects of the depreciation rules.

This piecemeal approach to simplification has not worked. The tax statutes have become even lengthier and more difficult to comprehend. And with new tax legislation now being passed almost yearly, it has become all but impossible to keep track of the changes in both the law and the forms.

It is time for a new tax system.

IN SEARCH OF A BETTER WAY

It should be for the Government - and not the taxpayers - to come forward with a better way to design and manage the Federal revenue-collecting function. Congress and the IRS are the experts, citizens are not.

In the absence of such reform, however, it falls to the citizens to propose their own. One of these is the Gross Income Tax (GIT) system, a simplified and equitable approach to tax collecting and administration.

The crucial underlying flaw in our present tax system is that it is based on net income. Net income is a figure arrived at by taxpayers and their accountants and depends primarily on the ingenuity of the taxpayer's accounting and investment system. By its very nature, a net income tax system - with its countless ways to reduce tax liability - is inequitable, hard to administer, wasteful in compliance and overhead costs, and frustrating in its complexity.

All of these problems could be solved simply by implementing a tax system based on gross income. GIT is just such a system. It is fair, it is efficient, it is workable, and most of all, it is essential if we are to prevent a taxpayer revolution and massive breakdown of Government.

Changing over from the present Net Income Tax (NIT) system to GIT would benefit everyone-individuals, businessmen, the Internal Revenue Service, the entire Nation.

* For employers, GIT would eliminate an estimated 90 percent of all recordkeeping and internal paperwork required for income tax preparation. W-2 forms no longer would be required, nor would quarterly reports to the Government c_ monthly payments. All information would be reported but once a year. Likewise, taxes, too, all would be paid at one time.

* For employees, few would have to file an income tax return under GIT and none would have to suffer the frustration of coping with incomprehensible forms and instructions.

* For the Government, GIT would mean complete control over how much revenue is collected, and when, and what social and economic goals are realized through the tax system.

In addition, the GIT system would insure that:

* Every taxpayer - whether an individual or a business - would pay a fair share.

* There would be absolutely no "loopholes," which allow some taxpayers to avoid practically all taxes even though their incomes may be in the millions of dollars.

* The Government would collect at least as much revenue as it does under the present NIT system, but at a vastly reduced overhead cost.

* The tax system no longer would be a major contributor to the insidious inflation that is eating away more and more profits and savings each year.

In short, GIT is an equitable, uncomplicated tax system that would generate sufficient revenue to the Federal Government drastically reducing the dollar, time, and paperwork costs inherent under the present NIT system.

HOW WOULD GIT WORK?

Under the GIT system, most individual wage earners (IWEs) would not file an income tax return. Instead, the IRS would collect Federal income tax and FICA by taking percentage off the top of the gross receipts of each company or business operating entity (BOE).

Once a year, each BOE would submit to the IRS both an income tax return and an information return. The income tax return, a copy of which is included here, would show the BOE's gross receipts. The information return would show how many IWEs the BOE had employed during the year and how much it had paid each employee. Along with these returns, each BOE would submit to the IRS the amount of Federal income tax it owned. This amount would be based on a percentage of the BOE's gross receipts. The percentage, which would be determined by Congress, would be the same for all business operating entities. Because GIT would broaden considerably the current tax base, this percentage, or tax rate, would be very low. It is estimated that the tax rate would be in the 4½% to 7½% range.

Based on the information it received from the BOE, the IRS would allocate to each individual wage earner his or her share of the income tax and FICA paid by the BOE for which he or she worked. The

IRS would then send each IWE a statement showing how much Federal income tax and FICA they had been credited with paying.

WHAT ABOUT DEDUCTIONS?

Each year, Congress would issue a list of items for which tax credits will be given. Credits offered could include those for employment (hiring), purchases of homes, charitable contributions, export sales, energy saving measures, or virtually anything that would be economically or socially advantageous for the Nation.

A BOE would claim its tax credits on the tax return it files with the IRS each year. The BOE would deduct the amount of tax credits from its gross receipts and would pay income tax only on the balance.

An IWE wishing to claim tax credits would fill out a simple form and submit it to the IRS with appropriate supporting documentation. The IRS then would issue the IWE a check, or direct payment, for the credits claimed. Thus, only those IWEs wishing to claim tax credits would have to submit a form to the IRS or keep supporting records throughout the year.

WOULD ANYONE ELSE HAVE TO FILE A TAX RETURN?

An individual who is self-employed would file as a BOE. Also, any person who received a substantial amount of unearned income would file as a BOE for the year during which that income was received. Such unearned income, which could include gifts, inheritances, long-term capital gains, savings bank interest, etc., would be taxed at the same rate applicable to all BOEs.

In addition, some high-salaried individual wage earners would be defined as BOEs for tax purposes. Such IWEs, who clearly are selling their expertise rather than contributing simple manual or mental inputs to their companies, are more properly considered business entities. Congress would set the salary limit above which an IWE becomes a BOE. If, say, the limit is set at $50,000, the IWE would file as a BOE only for the income earned above $50,000. Tax on the salary up to $50,000 would be allocated (as for all IWEs) on the basis of the tax and information returns filed by the employer.

WOULD IT BE HARD TO CHANGE OVER FROM NIT TO GIT?

There is no doubt that it would take some time for individuals and proprietors of businesses to get used to a tax system without such ingrained notions as depreciation, deductions, or capital loss carryovers.

Of course, the reason these and other devices exist is <u>because</u> of the NIT system itself. The GIT system does not <u>need</u> such devices to attain fairness and equity.

So, the first step in changing over from the NIT system to the GIT system is to understand that no one will be losing anything. IWEs would take home the same amount of money under GIT as they do under NIT. The difference between their gross and take-home salaries under NIT would simply become their allocated tax share under GIT.

Likewise, businesses would not lose anything either under GIT. Even if a particular business should end up paying more taxes under GIT, this increase would be more than offset by the significant savings that would be realized in the year-round costs associated with tax reporting and preparation under NIT.

WHY SHOULD WE CHANGE FROM THE NIT SYSTEM TO THE GIT SYSTEM?

1. GIT would reduce drastically the complexity of the tax system. Complexity is inherent in any tax system based on net income. Under such a system, it becomes the objective of all taxpayers - businesses and individuals - to reduce their taxable (net) income to the barest minimum. This is accomplished by using such devices as deductions, shelters, etc.

Because every taxpayer has a unique taxpaying situation, countless different approaches to minimizing taxable income have evolved over the years. While Congress has passed hundreds of complex amendments to the tax code, the IRS has issued even more complex regulations - all in an attempt to control the situation, to make sure that one group does not benefit unduly at the expense of another.

But so long as the tax system is based on net income, Congress and the IRS will never gain control of the situation. They will constantly be called upon to extinguish - through yet another complex amendment regulation - whatever brush fire exists at the time.

GIT would eliminate this never-ending cycle of unfairness and complexity. Because taxes would be paid right off the top of gross receipts, no taxpayer would be treated preferentially and thus no amendments would be needed to correct inequities. There simply would not be any under GIT.

2. The GIT system would reduce significantly the astronomical costs associated with Federal tax compliance and administration. Individuals, businesses, and the Government all would realize substantial savings under GIT. By employing the principle of allocation, GIT would relieve the overwhelming majority of individual wage earners from the burdens of filing a Federal income tax return and keeping tax records throughout the year. Moreover, those IWEs who currently rely on a professional tax preparer would realize significant dollar savings as well.

The cost of Federal tax compliance also would plummet for businesses under GIT. By eliminating the need to compile and report

data monthly and quarterly, GIT would reduce business overhead to a fraction of its current level. In addition, those tax lawyers and accountants who currently must work full-time handling the tax matters of their companies could, under GIT, focus their efforts instead on the real purpose of business - capital production.

For the Government, the NIT system, with its countless provisions to meet equally countless individual taxpayer situations, is extremely difficult and costly to administer. The true cost, however, will never be known because the administrative costs are only the tip of the iceberg. The really huge costs are the taxes lost because of loopholes. Some say that hoopholes are necessary to accomplish certain social and economic goals. The fallacy in this statement is that, under the NIT system, only certain classes of taxpayers can take advantage of these loopholes, so that the vast majority of taxpayers reap no social or economic benefits.

The GIT system, with its simplified, straight-forward method for providing tax credits, also could be used to promote social and economic goals, but with much more effectiveness and at a drastically reduced cost.

3. The GIT system would tax individuals and businesses on the basis of their true ability to pay. It is a cardinal democratic principle that an income tax should be based on ability to pay. Under the present NIT system, however, the greater one's resources, or ability to pay, the greater one's ability to avoid taxes. This is an inherent weakness in any tax system based on net income, because each individual taxpayer determines for himself what deductions he can take. Thus, the greater one's resources, the more likely it is that tax lawyers and accountants can be hired to find loopholes that will mitigate one's tax liability.

Moreover, under the present NIT system, it is possible for almost any business to earn a large real profit, but, because of various loopholes, show - and pay taxes on - only a slight net profit. This can be accomplished, for instance, by spending most of the firm's profits on tax deductible items. This, under the present NIT system, if two companies have equal gross receipts and one spends its profits on tax deductible business expenditures while the other puts its profits into the bank, the first company would pay far less tax than the second, despite equal abilities to pay.

By permitting only some individuals and businesses to reduce their tax liabilities through various tax deductions and preferences, the current tax laws and regulations unfairly shift the burden from one segment of society to another. All taxpayers end up shouldering the expenses of the relatively few who can take advantage of tax write-offs.

The GIT system would eliminate all preferential treatment. Every IWE and BOE would pay an equal percentage of tax on gross earnings. And in place of the current arbitrary and unwieldly mish-

mash of deductions, preferences, and various other loopholes, it would be a more limited and controllable system of tax credits.

4. GIT would generate at least as much, and probably more, revenue as they present NIT syste. By ending all deductions, exclusions, shelters, and various other forms of preferential treatment, the GIT system would vastly increase the amount of money flowing into the Federal Treasury. Naturally, much of the effect of such a greatly broadened tax base would be mitigated by the sharply lower tax rate that would accompany such a broadening. However, because the tax base would be so broad under GIT, to effect even a substantial rise in revenue would require but a minute increase of the tax rate.

Moreover, the GIT system would put an end to the loss each year of millions - if not billions - of dollars that escape through improper use of deductions and other tax preferences. Under the present NIT system, with each taxpayer adopting a different approach to minimizing their tax liability, the IRS cannot hope to monitor taxpayer compliance effectively. Under the GIT system, the simple procedure for claiming tax credits would reduce the likelihood of taxpayer misunderstanding and consequent misuse of a provision. In addition, the GIT system, by providing for a tightly controlled, limited number of tax credits, would facilitate IRS verification of their proper use.

Moreover, the GIT system would add millions of dollars in overhead savings. With fewer tax forms to print, distribute, and process, and lower costs all around for insuring tax compliance, GIT would contribute to a more abundant Federal coffer.

5. The NIT system is highly inflationary. One of the primary causes of inflation today is the NIT system. To comply with all the tax and information reporting requirements throughout the year, businesses must invest huge sums for the services of bookkeepers and tax accountants. Moreover, because the NIT system is based on net income, most businesses find it necessary to maintain two different accounting systems. While the first is used to operate the business from an economic standpoint, the second is used to operate the business with an eye toward tax consequences. It is the latter accounting system that will determine, for example, whether a company will buy or lease property or equipment. Often, numerous tax lawyers and accountants are needed to discover and implement devices that may be used to lower a company's tax liability.

The cost of all these tax-related services is, of course, added to the purchase price of the goods produced. But since nothing has been added to the intrinsic value of the product, the cost of these services is inflationary.

The NIT system is inflationary in another way, too; namely, because of the large sums of money the Government must spend to administer it. This includes the costs of printing and distributing the plethora of IRS tax forms and instructional booklets and of

monitoring tax compliance - a virtually impossible task considering the innumerable different taxpaying situations of individuals and businesses.

Under the GIT system, tax and information reporting requirements would be reduced to once a year, thereby reducing substantially the costs to business for compliance. Additional savings would be realized by maintaining only one accounting system. Because taxes would be paid based on an objective determination of gross income- rather than a subjective determination of what is net - companies would have no need to operate on a tax-consequent basis. Thus, overhead costs for tax-related expenses would virtually disappear from the purchase price of goods and services.

Overhead costs for Government administration of the tax system also would take a nosedive under GIT. First, since most individual wage earners would not have to file a return, there would be fewer tax forms to print, distribute, and process. Moreover, because the returns filed by BOEs would be simple to fill out, the likelihood of an error would decrease and so, therefore, would the cost of correcting returns and collecting the right amounts due. Finally, audits would be far less time-(and dollar-)consuming under GIT. Because taxes would be paid on gross receipts, the need to rule on the legitimacy of countless different kinds of deductions would be eliminated.

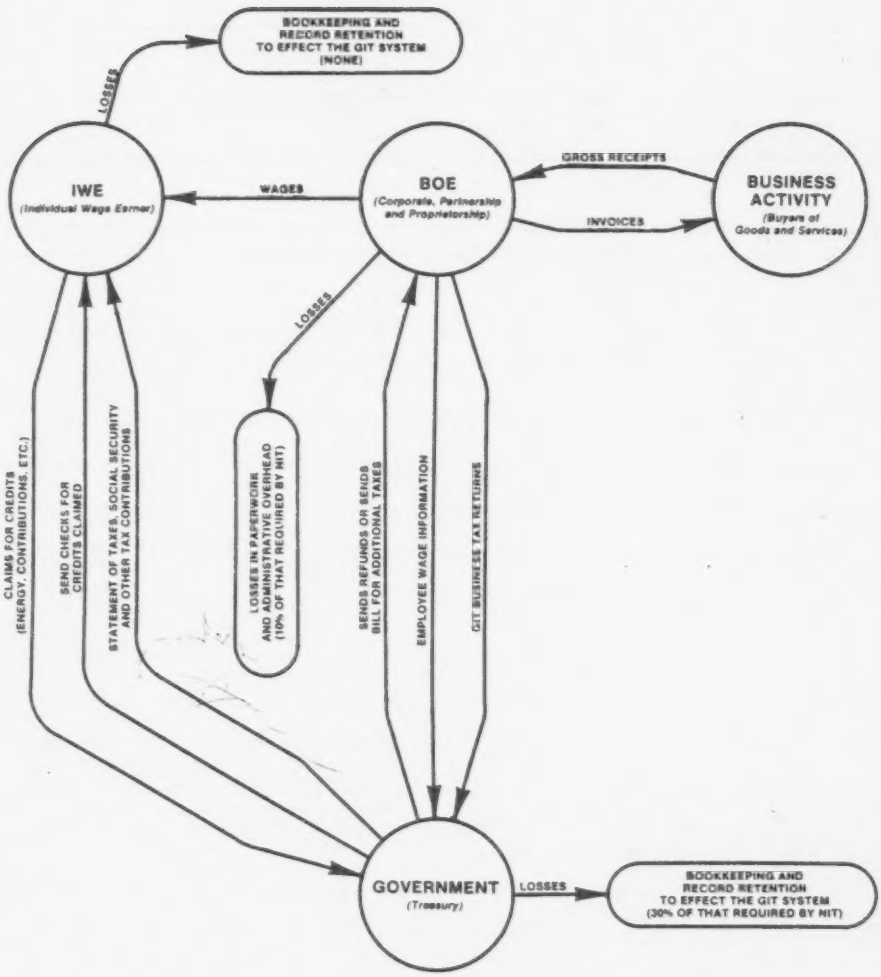
These are only some of the many reasons why GIT makes sense. For additional reasons and a more technical examination of the GIT system, please fill out and mail form provided.

* * *

The United States enjoys a richly deserved worldwide reputation for producing the best managerial talent of any advanced industrialized nation. This is the country that designed systems to develop the atomic bomb and to put the first man on the Moon. Yet this Nation's Government has not yet come up with an equitable, rational tax system that can be understood by everyone.

There are be no doubt that Congress possesses the ingenuity to design a simple, rational tax system. Its ability year after year to legislate new tax loopholes for one group or another is evidence of that. The time has come, however, for Congress to apply that ingenuity to creating a system that will take the "ouch" out of the tax bite, not just for some but for everyone.

The two following pages show schematic diagrams of the work flow for both the NIT and GIT systems. Fig. A show the NIT system. It is quite evident that we have produced an administrative nightmare. Now look at Fig. B. Here is the work flow for GIT. It is clean,



GIT SYSTEM

ADMINISTRATIVE WORK FLOW

Figure B

simple and produces its tax revenues at far less inflationary costs than NIT.

The next shows an illustrative Gross Income Tax return. A study of the boxes shown around this form will show that the GIT system can accomplish the same results as our present NIT system, but at much less cost.

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14 GOOD REASONS TO SWITCH TO GIT

1. It is fair and equitable to every taxpaying entity, whether it be a corporation, an individual businessman, an investor or a wage earner.

2. It is a progressive tax based strictly on the ability to pay.

3. It is easy to administer and would not make taxpayers dependent on the subjective and arbitrary decisions inherent in any tax system based on net income.

4. It is a true and equitable way for companies to accumulate capital. This encourages retainage of funds for expansion investment, thereby creating more jobs.

5. It would eliminate the so-called "Double Taxation" of corporations. This would again encourage retainage of funds for expansion because there would be no conflict between paying out for dividends versus retaining money for internal use.

6. It would eliminate an estimated 90% of the paper work for BOE's (Business Operating Entities).

7. It would eliminate an estimated 95% of the paper work for IWE's (Individual Wage Earners) - they would not file a yearly tax return.

8. It would allow business entities to operate on an economic basis rather than on a tax consequent basis.

9. It would raise more revenue than our present "system" allows, without substantive objections from the general public.

10. It would give equal opportunity to all business taxpayers. Large firms can employ lawyers and accountants to find all available preferences under the present system. GIT would eliminate this discrimination without penalizing either the large or the small company.

11. It would provide Congress more control over the tax system and would permit greater flexibility in funding Federal programs and promoting social and economic goals.

12. It would insure the Government a steady inflow of revenue and would discontinue the current practice of interest-free borrowing from businesses and employees.

13. It would provide businesses and the Government the predictability they need for efficient operation.

14. No longer would any wage earner in the country have to file a Form 1040, thus eliminating the April 15th national trauma.

Senator MATTINGLY. In conclusion, I would like to say in this country we have had an economy that's been stifled. It's very similar to having a room that has a locked door and there were two locks on that door. One was a tax lock and one was a spending lock. In 1981, we found the key to the first lock. In 1982, I believe what we need to be looking for is the key to that second lock, the spending lock, and that area that we need to be looking at is in the reform of the entitlement program of this country.

Economic recovery and economic growth of the United States has been stifled by this tax code and the manipulation of it by a $99 billion tax package is not going to make things any better. I think that we need to look to that second arena, that second lock, to this economy.

In conclusion, I would like to say I look forward to your testimony today. I think Mr. Roberts is the first one to testify.

STATEMENT OF PAUL CRAIG ROBERTS, WILLIAM E. SIMON PROFESSOR OF POLITICAL ECONOMY, CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES, GEORGETOWN UNIVERSITY

Mr. ROBERTS. Thank you very much, Senator Mattingly. I have my prepared statement for the record and a very short statement I would begin with.

The current tax code is highly progressive and riddled with deductions and exemptions. The result is that some income is highly taxed and other income is not taxed at all. In fact, the large industry that is expert in shifting income from high tax to low tax areas is growing. Even worse, under the current tax code, it often pays for people in high brackets not to make profitable and productive investments that would increase both their taxable income and improve the higher employment that would result from the income from others. Instead, it pays for them to purchase tax shelters that lower the rates on their existing income.

There's something wrong with a tax system that lets people do better by minimizing their taxes than by maximizing their earnings.

The rising rate of unemployment over the last decade is one of the costs of the tax system that encourages capital to move out of productive investments and into tax shelters.

A flat rate tax would eliminate all deductions and exemptions, taxing all income at the same rate, and since the tax base would be much larger, the tax rate would be much lower. Something around a 13 percent flat rate tax would raise the same revenues as the existing progressive income tax.

Such a reasonable tax rate would encourage people to use their talents to maximize their taxable incomes rather than to avoid taxes.

Is a flat rate tax fair? Definitely. First, it treats all income the same, whereas the current tax system discriminates in favor of and against different sources of income. For example, there's nothing fair about taxing income from private pensions but not from social security pensions or taxing income from savings accounts and investments at a higher rate than income from wages and salaries or taxing wages from overtime higher than wages for a normal workweek. These are just a few of the many ways in which a progressive tax system discriminates against different sources of income.

Second, a flat rate tax would treat all individuals and households the same, whereas the current tax system discriminates against individuals and households on the basis of marital status and the size of income. For example, the current tax system discriminates against married income earners and against people who achieve financial success by requiring them to pay a disproportionate share of the tax burden. This is an anachronism at a time when all other forms of personal discrimination—race, sex, and age—have been declared illegal.

Fairness is requiring a person or household with 10 times as much income to pay 10 times as much in taxes which is what a flat rate tax does. No one has ever proved nor can it be proved that fairness is requiring a person with 10 times as much income to pay 20 times as much in taxes. The ability to pay argument in favor of soaking the rich does not claim that a progressive tax system is fair. It merely says that the rich can be treated unfairly because they are better able to afford it.

The transition to a flat rate system would be difficult or easy depending upon whether the gains and losses of the transition would balance out. For example, homeowners would lose their mortgage interest deduction but they would gain from lower withholding and from a lower marginal tax rate on all forms of income, whether from a raise, overtime, investment or whatever the source.

An income exclusion could be instituted to protect lower income earners. The exclusion would introduce de facto progressivity into the system and only taxpayers with above median incomes would pay the full flat rate.

In addition to fairness, there are important economic gains to be had with a flat rate system. All taxpayers would be allowed to keep a much larger percentage of all future income earned whether from a raise or promotion, overtime, or saving and investment. This would improve incentives and the financial independence of the American people.

Part of the tax burden would be shifted from currently taxed productive activities to activities that are now off the books in the underground economy. In addition, the tax burden would be shifted to capital that is currently employed in tax shelters where it produces tax savings instead of taxable income.

A low flat rate tax would make shelters or off-the-book activities less profitable and bring many of those activities and that capital back into the tax base.

A flat rate tax would improve the fairness and efficiency of both the tax system and the economy.

Thank you.

[The prepared statement of Mr. Roberts follows:]

Prepared Statement of Paul Craig Roberts

I am grateful for the opportunity to appear before your Committee today to discuss the issue of flat rate taxation. In my opinion, a flat rate tax has great potential and deserves serious consideration. If it were available in the present situation, the budget could be balanced without the need for heavy cuts in spending or undesirable increases in taxes. The average and marginal rates of taxation could be much lower than under the present system and incentives to work, save and invest would be much higher. Furthermore, a flat rate tax would have the overwhelming advantage of simplicity and fairness. That might help insure that taxes actually get paid.

No one can fail to be dismayed by growing indications that a great deal of economic activity is currently being conducted "off the books" and out of the view of the tax collector. Studies by the Internal Revenue Service indicate that the gap between how much income tax should be paid and the amount actually being paid is approaching 90 billion dollars a year and growing. The current tax system is very complex and it is widely regarded as being unfair. Both factors have eroded confidence in the tax system and are undermining the motives for voluntary compliance. Special interest groups and tax accountants are the only obvious beneficiaries of the existing patchwork of special rules and regulations. Former Treasury Secretary William E. Simon summed the matter up very well when

he said that the Nation deserved to "have a tax system which looks like someone designed it on purpose."

A basis for such a design of the tax system was set forth in January 1977 in the Treasury Department's Blueprints for Tax Reform. It must be conceded that the Treasury proposals to simplify the tax system and enlarge the tax base did not go anywhere in 1977. Why would they have a realistic political future now?

The present situation is one in which "business as usual" does not appear to be a very attractive option. There is heavy political pressure to reduce the projected large budget deficits, but no political consensus on how the job can be done. Sufficient cuts in nondefense spending are not at hand and the need for a buildup in defense spending is widely recognized. Raising taxes -- or enhancing revenues as OMB prefers to term it -- undercuts the supply side approach which is the most promising economic initiative of the postwar period. Even those who were never advocates of supply side economics must find tax increases a curious policy when the unemployment rate is at a postwar high.

In short, there is a serious disharmony in the current set of policy initiatives regarding the budget. It would be far better to abandon the ceaseless effort to compromise our budgetary problems and make an imaginative effort to solve them. In such

a setting, the proposal for a shift to flat rate taxation could play a crucial role.

An update of former Treasury Secretary William E. Simon's "Blueprint for Tax Reform" reveals that a 16% flat rate tax on personal and corporate income would balance the 1983 budget.

There are variations of the flat rate tax that retain elements of progressivity without defeating the purpose of the tax. A 19% flat rate tax, for example, would balance the 1983 budget and allow the first $6,000 of income to be excluded from tax. That drops the tax rate on a $10,000 income to 7.6% and on a $20,000 income to 13.3%. Alternatively, an 18% flat tax would balance the 1983 budget and allow all transfer payments including Social Security to be excluded from the tax base.

The computation of these flat tax rates is done on a static basis. The larger tax base reflects only the addition of the deductions or so-called "tax expenditures" to the tax base. The expansionary effect on the tax base of better incentives from a low marginal tax rate are not included. Neither does the tax base include the economic activities that would be brought back onto the books from the underground economy nor the benefit to the economy of capital moving from tax shelters to productive investments. And the tax base does not include the economic efficiency gains to the economy of taxing all income at the same rate and eliminating tax-induced distortions in the rate of return

structure and investment decisions. When all of these positive effects on the tax base are taken into account, the rate of tax needed to balance the budget would be lower than 16 percent. Alternatively, unless spending goes out of control, a 16 percent rate would produce surpluses that could be used to pay down the national debt. Another possibility, long favored by many economists, would be to limit the tax base to consumption spending -- in other words remove saving from the tax base. Measured on a static basis, this would push the required flat rate higher but would remove a disturbing feature of the existing tax system. As matters stand, savings are taxed twice: once when the income is earned, and again when the saving yields a return. With the social security system under pressure and the economy badly in need of more private saving, a shift to a flat rate tax on consumption deserves serious consideration.

Another major benefit from moving to a flat rate tax would be the lowering of marginal tax rates and the strengthening of economic incentives. There is widespread recognition of the desirability of achieving lower marginal rates and this was a major thrust of last year's Economic Recovery Tax Act. As things are working out, however, there will be much less reduction in marginal tax rates from that legislation than originally contemplated. The personal tax reductions are coming in piecemeal form and are being washed out by bracket creep and rising payroll taxes.

The future of indexing, scheduled to commence in 1985, has fallen under a cloud with the state of the budget having become such a dominating concern. On the business side, the favorable effects on incentives are already being reversed as budget compromisers search desperately for new sources of revenue. At one stroke, a flat rate tax could provide a dramatic increase in economic incentives and yield a balanced budget. No similar claim can be made for any other policy that is under active discussion.

Imagine a world free of bracket creep, high interest rates, capital shortages, marriage penalties and penalties for success. Imagine the end of the underground economy and the improvements in economic efficiency that would result from eliminating the numerous distortions in the tax code. Not least of all, imagine being able to quickly and easily prepare your own income-tax form.

The administration and Senate Republicans are leading the President in the wrong direction. In an effort to hold on to tax cuts that still leave marginal tax rates far too high, Mr. Reagan is being pushed toward eliminating deductions and exemptions on an ad hoc basis. Better to eliminate them all at once and get meaningful tax rate reduction in exchange, not to mention full funding for Social Security, education and national defense.

Is all this too good to be true? What are some of the problems that would be faced in moving to a flat rate system of taxation?

The transition to a flat rate system would be difficult or easy depending upon whether the gains and losses of the transition would balance out. For example, homeowners would lose their mortgage-interest deduction, but they would gain from lower withholding and from a lower marginal tax rate on all growth in income whether from a raise, overtime, investment or whatever the source.

Distributional gains and losses are an important consideration and some adjustments might have to be made. However, there is a risk in concentrating too narrowly on distributional questions especially in static terms. Economic growth is still the engine of progress for most taxpayers and particularly for those at lower income levels. A flat rate tax should restore economic incentives and trigger a growth process in which everybody wins. The economy and the tax system do not yet constitute a zero-sum game, although we are drifting more or less steadily in that direction.

Those who are concerned over the distribution of income might well ponder the question as to how effective the tax system has been, or can be, in achieving redistributive goals. Most evidence suggests that it is government transfer payments which are

primarily responsible for the shifting of purchasing power to lower income brackets. Efforts to achieve redistribution through the tax system are largely ineffective. The major result has been to discourage the rich from earning taxable income. The resulting tax burden on the middle class becomes oppressive. It would be more sensible to use the tax system as an efficient instrument to raise revenue and promote economic growth. If income redistribution is necessary, it should be pursued through the expenditure side of the budget. The way we are headed now is placing a heavy overload on the tax system. Clear warning signals have arisen in the form of sluggish productive performance and large budget deficits.

There are a range of technical issues that would arise with a move to flat rate taxation which would require study and analysis. The major issue would be the base of the tax, whether income or consumption, and the exclusions, if any, which would be permitted. There would also be technical questions concerning how the transition to a new system could be made most smoothly and equitably, but it would be a mistake to become bogged down in an elaboration of all of the possible technicalities. Complex tax provisions are not essential to our welfare, what must be recognized first is that an overriding requirement for public support is that the tax system be simple, understandable, and even-handed. In the tax area, we nave gone so far in the direction of administrative, legislative and

economic complexity, that the tax system is undermining productive effort and is in danger of losing public support. We badly need a simple and understandable tax system that will provide adequate rewards for saving and work effort in the private sector. In my opinion, a flat rate tax could be designed so as to meet these crucial requirements. Our present tax system is failing to meet the Nation's needs and is badly in need of basic reform.

Reform, however, does not mean simply closing loopholes. Many of the so-called "tax loopholes" were put into the law because certain activities were being smothered under the blanket of high tax rates. The loophole is a lifeline that lets the activity continue to breathe under the layer of taxes. If the tax rates are lowered, the loopholes are not necessary. If the loopholes were closed without lowering the tax rate, the activities would be smothered, in which case no revenues would be raised.

Tax reformers who want to close the loopholes but maintain the progressive income tax and the high statutory tax rate on corporate income often campaign under the banner of "equity." In actual fact, a progressive income tax system is discriminatory (as is the double taxation of dividends). The current U.S. tax system discriminates according to size of income, source of income and marital status. The progressive income tax is an

anachronism in a society that has declared all other forms of personal discrimination-- race, sex and age -- illegal.

There is nothing fair about taxing income from private pensions but not from social security pensions, or taxing income from saving accounts and investments at a higher rate than income from wages and salaries, or taxing wages from overtime higher than wages from a normal workweek. There is nothing fair about discriminating against married income-earners and against people who achieve success by requiring them to pay a disproportionate share of the tax burden.

Fairness is requiring a person or household with 10 times as much income to pay 10 times as much in taxes, which is what a flat rate tax does. No one has ever proved, nor can it be proved, that fairness is requiring a person with 10 times as much income to pay 20 times as much in taxes. The "ability to pay" argument in favor of soaking the rich does not claim that a progressive tax system is fair. It merely says that the rich can be treated unfairly because they are better able to afford it.

The fairest society is the one that provides the most opportunities for people to succeed. In this sense as well the current tax system is unfair.

Senator MATTINGLY. Mr. Bradford.

STATEMENT OF DAVID F. BRADFORD, PROFESSOR OF ECONOMICS AND PUBLIC AFFAIRS, PRINCETON UNIVERSITY, AND DIRECTOR OF THE RESEARCH PROGRAM IN TAXATION, NATIONAL BUREAU OF ECONOMIC RESEARCH

Mr. BRADFORD. Thank you, Senator Mattingly. I'm afraid I got a little carried away in my prepared statement and managed to submit some 19 pages of single spaced text for my statement today. I'll try to move through a summary of it if I can. I will take a little longer than Mr. Roberts because I have some technical detail which I think may be of interest.

Senator MATTINGLY. Very good. I know sometimes it's difficult to say good things about taxes.

Mr. BRADFORD. The interest shown recently in proposals for a flat rate tax reflects continuing dissatisfaction with the U.S. income tax. Three major complaints may be distinguished. The Senator pointed them out. The tax law is too complicated. The ordinary taxpayer cannot understand it. High tax rates induce people to evade the law or at least to waste resources on reducing taxes instead of producing something useful. The third complaint widely held is the belief that the well-to-do taxpayers can afford to take advantage of loopholes and thereby avoid paying their fair share of taxes.

Proponents claim that a flat rate tax would vastly simplify the tax law and that the lower rates associated with a broadened based will reduce the distortions caused by the current law. They sometimes also claim that a flat rate tax can be as progressive as the existing income tax.

I'd like to comment briefly on the complaints that people have made about the tax system and the capacity of the flat rate proposals that I'm aware of to deal with those complaints.

When I served in the Treasury Department I had the good fortune to direct the staff of the Office of Tax Analysis in a study of the tax system at that time. This was in 1976. And we produced at the behest of Secretary Simon at that time a document entitled "Blueprints for Basic Tax Reform." This study represented a careful look at the possibility of what could be achieved by way of broadening the base and lowering the rates through development of alternative principles of the underlying objective of the tax system, and two plans were developed.

Both of them were designed to replace the combination of individual and corporate taxes that we have now. The first plan was called the comprehensive income tax and it implements the notion of income as the sum of consumption and savings during the year, familiar to tax policy theorists. And the second plan was called the cash flow tax and it implements the idea of basing tax on the long-term level of consumption of the household or individual.

Well, we were able in the context of that study to produce data on the likely actual degree of progressivity and the actual incidence of taxes that prevailed in our tax system at that time and I would direct your attention to table 1 of my prepared statement which I hope you have.

I mentioned that we developed two separate ideas of the objective of tax; one, we called comprehensive income; and the other we called cash flow. So to correspond to that, I laid out in table 1 ratios of tax burdens to income levels by these two definitions. The columns labeled "1976 Law" show what we believe to be the burden of tax borne by households of different income levels at that time. The 1984 law gives my guess about what the facts would look like today. I would have to say that's a very rough adjustment of those figures, taking into account the reduction in rates in 1981 and the bracket creep and erosion of other aspects of the tax law by inflation.

I might point out as probably is well known that the 1984 law would raise a lot more revenue, at least in the individual income tax, than would the simple inflating of the 1976 law to take account of the shift in brackets and exemptions.

Well, if you look at the far right in the columns in table 1, for example, the 1984 cash flow rates, effective rates, I'm looking at the ratio of tax to income of households of different income level and you can see that according to our estimates its ascends steadily from zero at the zero level to a high of just under 30 percent for the very highest income taxpayers.

Well, as I say, these data were very carefully put together. They are no doubt not perfect. But I think they certainly refute the notion that somehow well-to-do taxpayers nowadays are not paying a fair share of tax. One can argue about what exactly the right share would be. Craig Roberts would have one view and I might have a slightly different one, but in any case there's a very clear pattern of progressivity in our existing tax system and so those who say that well-to-do taxpayers are totally avoiding their fair share are I think very much in error.

However, I think as a consequence of that we have to say that a shift to a flat rate tax on a very broad income base—and either of these bases I've mentioned and displayed in table 1 are very, very broad income bases, as wide as you're likely to see under any version of a flat tax—a shift to a single flat rate of tax would make a marked change in the degree of progressivity of our existing tax system.

Now that's true even if we were to adopt—the burden would be very dramatically redistributed even if we were to adopt a large exemption coupled with a flat rate tax and I display in table 2 of my prepared statement the typical sort of effective tax rate calculation we would get for households with different cash flow income under an illustrous tax rate plan of which the details are provided.

One can see that that particular pattern, that particular plan according to my guess, would be roughly of the same progressivity as the existing tax system, but it would have very different tax implications from our present system. There would be a lot of redistribution that would be brought about, perhaps desirable, but one would have to face that fact.

However, the next thing I'd like to talk about is the effect of tax rates on individuals' behavior and that is the concern that people express when they say that high tax rates are inducing people to evade the law or to waste resources in seeking to minimize taxes. The point I would emphasize here is that these problems are not simply problems of the rate. They are problems in the consistency with which we have approached the problem of the tax base.

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What we are very sorely lacking is a thorough, ongoing and consistent notion of what it is we are trying to tax, be it consumption or income, and, as a consequence, we have a hodge-podge of rules which invite the taxpayer naturally to seek out ways to minimize their burden and they do this in all kinds of ways.

I provide in the text of my prepared statement—I won't go through it—an example of the way in which a taxpayer is not only invited to borrow money to purchase an asset which will realize its return in the form of capital gains. This is a well-known so-called loophole in our present law. Whether it is good or bad, it does invite taxpayers to distort their portfolio decisions. And as my example demonstrates, the pressures to do that are very dramatic. There's a very high reward for a taxpayer by shifting from an ordinary taxed asset, borrowing and buying an asset which generates its gain in the form of capital gains.

The interesting thing is that my example is the case of the 50 percent marginal tax rate and we have our present long term capital gain preference. I then provide in the text the example of what happens if we cut the tax rate to a flat 25 percent and go through the same exercise to illustrate the distortion problem, to show that in fact the payoff of the same transaction, borrowing to buy the asset which accumulates in value in the form of capital gains, is even greater when all gain is included as ordinary income on realization and at the lower rate.

The problem in this case—and I say it's a technical point and there are many such points—is that we don't have a very consistent approach as to how we are going to tax the accrual of gains by the taxpayers and when we do it in the form of the realization basis, which is the way we approach capital gains—you're taxed when you sell the asset—we're doing it differently than we tax a savings account and the consequence is a very, very enormous distortion in incentives even with a fairly lower rate.

So simply dropping the rate is also not going to solve the very important incentive problems in our tax system.

What is going to solve them, if anything, is the shift to a very carefully thought through and consistent tax base. I indicated that in the blueprints report I think we developed such tax bases, one on the basis of the notion of income, and the other essentially on the basis of consumption; and I think these are the two serious contenders for a broad-based, individualized tax.

I'd like to just refer you to table 4 in my prepared statement which is a very complicated thing. You will find—some people at least will find the small printed version which has all the same information in table 4—to indicate the problems that one faces in trying to do it right, so to speak, to do an income tax right or a cash flow tax right.

The income tax would be basically familiar, although if anybody who studies table 4 which indicates how you attach different transactions—interest, wages, pensions, and what-not—anybody who studies table 4 will find some unfamiliar treatments under the income tax, but the cash flow tax will no doubt be less familiar to many, but in my view it has very, very great advantages.

The cash flow tax is a form of consumption tax. It says to the saver, "We won't tax you on return on your savings. If you decide to put your money aside to consume in the future, we won't increase your tax burden." That turns out—just to make that simple a change in

the base of our tax—turns out to be a tremendous potential for simplification.

Senator JEPSEN [presiding]. May I interrupt you, Mr. Bradford? Given the choice between a flat tax rate and on consumption tax with higher progressive marginal rates, which would you prefer?

Mr. BRADFORD. If you're talking about the cash flow tax, I would prefer the cash flow tax.

Senator JEPSEN. You just indicated this was a form of consumption tax.

Mr. BRADFORD. Right. I would be concerned about the details of the consumption tax. That's all I'm indicating by that answer.

Senator JEPSEN. Well, can one argue on equity grounds that we should tax consumption rather than income?

Mr. BRADFORD. I think so. I think, in my viewpoint, it's arguable. Obviously, equity is hard to give a precise definition to. To my point of view, it's a more equitable base than income.

Senator JEPSEN. Right now Americans are saving 6 percent plus basis of their disposable income. It's heading in the right direction. It's on the way up. What would they save with a flat rate, broad-based tax on consumption?

Mr. BRADFORD. What would they save? I understood you to say what would they save. My own guess is they would save substantially more. I think it's very hard to be precise on the quantity.

Senator JEPSEN. Well, some critics of our tax system now say that not only does it discriminate against saving and investment but leads to inappropriate forms of savings and investment. Do you agree with that?

Mr. BRADFORD. I am in that camp wholeheartedly. I think it's a very, very serious problem with our tax system. It may be that the misdirection of saving and investment is even more important than the burden of tax on saving, although I would favor eliminating the burden of taxing on savings as well.

Senator JEPSEN. Could you give me an example of how you think it's misdirected?

Mr. BRADFORD. Well, let's take my example of the capital gain asset versus an ordinary income asset. Now the trouble is, how do I find a good example of a capital gain asset. Let's take the difference between a dividend paying stock and a nondividend paying stock. There's no reason that I can see why we should favor one form over the other. The dividend paying stock would be much more heavily taxed than the nondividend paying stock and we would therefore, by our tax system allocate resources from a dividend paying stock to a nondividend paying stock. That would be a very small example.

Of course, many of these distortions we have adopted on purpose. I regard many of them as questionable but we give favorable depreciation treatment to different forms of assets to certain industries on purpose precisely to achieve a distorting of the result of the tax system. But I think many of them are inadvertent. We have a strong bias now, especially in time of inflation, toward debt finance of the corporate sector and I think we are living to regret that. We have a bias against dividends. We have a bias against savings in general. We have a bias in favor of capital gain assets. We could go on. There are many, many of them.

Senator JEPSEN. Isn't the bottom line on the consumption tax, very simply stated, those who buy most pay most?

Mr. BRADFORD. That's a good simple statement of it.

May I proceed?

Senator JEPSEN. Yes. Please do.

Representative RICHMOND. As long as our chairman has interrupted, I think I will too, Mr. Bradford. Mr. Bradford, is the flat rate tax used anywhere in the world today?

Mr. BRADFORD. Well, a value added tax.

Representative RICHMOND. I'm talking about a flat rate tax.

Mr. BRADFORD. For any individualized flat rate tax, not to my knowledge.

Representative RICHMOND. So, nowhere in the world do they have this system?

Mr. BRADFORD. Not to my knowledge.

Representative RICHMOND. This flat rate tax is for individual tax returns, right? I think that's what you were suggesting. What's the concept for business taxes, corporate taxes? How would flat rate taxes alter our present corporate taxes?

Mr. BRADFORD. Well, it would depend very much on the particular flat rate tax. The Hall-Rabushka plan, which is one this subcomimttee heard about a month ago, is one which would tax businesses and individuals at the same rate.

Representative RICHMOND. And you and Mr. Roberts I believe said that if we had a flat rate tax, the effective tax rate for everybody—in other words, a flat rate tax has no deduction whatsoever, is that correct; no interest deductions, no mortgage deductions?

Mr. BRADFORD. It's a question of policy. Most proposals have none. You could have them.

Representative RICHMOND. As soon as you start having deductions it's no longer a flat rate tax.

Mr. BRADFORD. The flat rate describes the rate at which the tax is assessed.

Representative RICHMOND. But taking the pure form——

Mr. BRADFORD. You could have a graduated tax from a flat rate tax.

Representative RICHMOND. Taken in the purest form, it would be a tax with no deduction whatsoever which obviously would make the tax reporting system infinitely simpler, and you and Mr. Roberts say that an effective tax rate of 16 percent would more than produce sufficient funds to balance the Federal budget, is that correct?

Mr. ROBERTS. Generally when you talk about the flat rate tax, the way you get the rate so low to replace existing revenues is that you do close out all the deductions.

Representative RICHMOND. Sure.

Mr. ROBERTS. And thereby expand the base. So, it's the expansion of the base that lets you lower not just the average rate of taxes but also the marginal rate of taxes. So that is true. Usually when you speak of a flat rate tax, generally—it does not necessarily mean that you don't have any deductions or exemptions, but to get the low flat rate it does mean that you eliminated deductions.

Representative RICHMOND. How do you get it as low as 16 percent, Mr. Roberts? You assume that the total income in the United States is $3 trillion?

Mr. ROBERTS. Roughly.

Representative RICHMOND. All right. Three trillion dollars, 16 percent of that is only $480 billion. How are you going to balance the national budget on $480 billion a year?

Mr. BRADFORD. What are we raising from the income taxes now?

Representative RICHMOND. Mr. Roberts in his statement here indicated that we're raising $300 billion now on individual income tax and under your plan we raise $480 billion. Is that correct? You know, this is not a bad idea actually.

Mr. ROBERTS. The 16-percent figure I supposed is based for the 1983 budget and——

Representative RICHMOND. And roughly $3 trillion income?

Mr. ROBERTS. Based on whatever the budget assumptions are. It doesn't include excise taxes and social security taxes and all of those things.

Representative RICHMOND. Using your system, we would have $480 billion of straight income from taxpayers, right?

Mr. ROBERTS. What are you taking as a tax base?

Representative RICHMOND. Three trillion dollars.

Mr. ROBERTS. Well, I don't know if that would be the correct tax base. I don't have all of my figures here to look, but——

Representative RICHMOND. Three trillion dollars are being paid out each year in the United States in the form of income to somebody.

Mr. ROBERTS. Well, are you talking about the gross national product or disposable income? If you're talking about gross national product, that's not generally the tax base.

Representative RICHMOND. All right. Then my question to you is, in your testimony you said that 16 percent effective tax rate would balance the Federal budget.

Mr. ROBERTS. If you want to know what the tax base it, that would be personal income minus the deductions or the so-called loopholes——

Representative RICHMOND. We just decided there wouldn't be any deductions under the flat rate.

Mr. ROBERTS. That's right. I mean plus the deductions. So throw the deductions in and your personal income plus what is called tax expenditure, but it won't be $3 trillion.

Representative RICHMOND. So personal income is $2.5 trillion. It gives you $400 billion, which is $100 billion more than we're getting now.

Mr. ROBERTS. That's what balances the budget, the extra $100 billion. So the figure I think is right. The 16-percent figure was the figure which would balance the 1983 budget and, therefore, it would be, if you agree with the budget estimates, $100 billion greater than currently.

Representative RICHMOND. I suppose the value added tax, a tax they have in many European countries, is in a way almost a flat rate tax, isn't it?

Mr. ROBERTS. It would be comparable perhaps to a flat rate tax in which income from savings was excluded from the tax base.

Representative RICHMOND. I think it would be a lot easier to administer a flat rate tax than the type of taxes we've got today.

Mr. ROBERTS. A value added tax?

Representative RICHMOND. No, a flat rate tax.

Mr. ROBERTS. A flat rate tax would probably be much easier to administer, yes. In fact, it would for sure be easier to administer.

Representative RICHMOND. On the other hand, you have the poorest of poor people paying 16 percent of their income and the richest of rich people paying 16 percent of their income.

Mr. ROBERTS. You could have that, but you could also have an income exclusion, and if you had an income exclusion, then, depending on what the exclusion was, you would have a de facto——

Representative RICHMOND. In other words, you would exclude anybody below the poverty level?

Mr. ROBERTS. You could do that, yes. And I think roughly $6,000 or $8,000 income exclusion would move your flat rate tax up. It would require about 18 percent, but this is all based on static measures. It doesn't count the gains to the tax base which would come from a flat rate tax such as the improved efficiency, the reallocation of capital, the reallocation of activities away from the underground economy.

Representative RICHMOND. It would simplify life for everybody, wouldn't it?

Mr. ROBERTS. Yes, it would.

Representative RICHMOND. Mr. Bradford, I'm sorry to bother you with interruptions. Go right ahead.

Mr. BRADFORD. Well, I should perhaps come to a close.

The point I would urge in fact is I guess a qualification in terms of your remark that a flat rate tax would simplify life. I think you would still have difficult problems of deciding whether a person had income when he sold a share of stock, when he received a dividend, when he received REIT, when he got a pension, when he made a pension contribution and so on.

Representative RICHMOND. No, not if you call it a flat rate tax. All income is income.

Mr. BRADFORD. Well, if you can identify it. Perhaps Mr. Kurtz can comment on the problem of identifying income.

The table that I indicated that displays the characteristics of the idealized income tax talks about what you would have to do to find out what income is and also identifies those items which would be involved in a very consistent carrying through of the notion of taxation on the basis of consumption, and those are indicated by the cash flow tax. And the point of the table, for those who are interested in some of the details of tax administration, is to indicate just how significant are the differences and how advantageous the consumption base is on simplification grounds. I think that the potential for doing it right are extremely great and the possibilities for doing the income tax right, taking into account the problem dealing with inflation as it affects income measurement, is quite grim. I don't think we're going to do well on that at all.

I also have in the prepared statement, just for your information, an illustration of the problem of what inflation does to income measurement and what happens to the interest earner, when inflation jacks up the interest rates from 2 percent to 15 percent when we have 13 percent inflation. The effect is rather dramatic even with very modest rates of tax.

Let me just conclude with a few remarks about two plans which I know are circulating. One is the Bradley-Gephardt bill which is very,

very broad based but one not on the flat rate category, involves a schedule of graduated rates of the kind that we now have.

In my view, the absence in that bill of very careful thinking through of these problems of consistency means that we would not get major advantages from that bill, sympathetic as I am with its efforts to adopt a broad base.

The other plan that I know of which I think has a great deal of promise is the one discussed at the last hearing, the Hall-Rabushka plan, which is of the cash flow type and it's very, very extraordinarily simple. I think it would very much fulfill your objectives as far as simplicity is concerned. It seems to me quite convincing of the possibility of doing that very, very simply and the question that I think the policymakers need to grapple with is, is one prepared to go with the implications of the flat rate as far as the distribution of the tax are concerned? My own view is that the level of tax outlined in the Hall-Rabushka bill, which I believe is 19-plus as a marginal rate, applicable to everybody above an exemption, would very dramatically redistribute the burden from the well-to-do to the less well off.

I think to avoid that we would need to tax more in the neighborhood of 30 to 35 percent of the margin. Whether that would then be attractive, I don't know. I think it's possible that it would be.

Representative RICHMOND. Mr. Roberts says 16 and you say 30 to 35. In other words, what you're assuming is that the people in the lower brackets would be graduated. They would be out.

Mr. BRADFORD. They would have an exemption.

Representative RICHMOND. Mr. Roberts' exemption is just below the poverty level.

Mr. BRADFORD. That's right. I would have a higher exemption. It would approximate the present degree of progressivity of our tax system as displaced in my prepared statement. You would need a much higher marginal rate. There's obviously no necessity to.

Representative RICHMOND. Unless you had graduated income from the poverty level to other levels.

Mr. BRADFORD. If you started graduating, then you're out of the simplicity advantages of the Hall plan and then you should be looking at the cash flow tax, in my opinion. I certainly recommend that.

Thank you.

[The prepared statement of Mr. Bradford follows:]

Prepared Statement of David F. Bradford

The interest shown recently in proposals for a flat-rate tax reflects continuing dissatisfaction with the U.S. income tax. Three major complaints may be distinguished:

(1) The tax law is too complicated. The ordinary taxpayer cannot understand it.

(2) High tax rates induce people to evade the law or at least to waste resources on reducing taxes instead of producing something useful.

(3) Because well-to-do taxpayers can afford to take advantage of loopholes, they don't pay their fair share.

Proponents claim that a flat-rate tax will vastly simplify the tax law. They sometimes also claim a flat-rate tax can be as progressive as the existing income tax.

None of the complaints listed is new. What we have to ask ourselves is whether a new opportunity exists to deal with the problems in a way that will stick. Or are we rather witnessing just another visitation of the "broaden the base, lower the rates" sentiment that, like the Asian flu, breaks out in the U.S. from time to time.

If the latter is the situation, I would hope the tax-writing committees would take an aspirin instead of developing new legislation. Earlier outbreaks gave us the tax acts of 1969 and 1976. It is very hard to see those efforts as part of progress toward a fair and simple tax system.

What may be new in the present is an increased awareness of the distorting effects of very high tax rates (as seen in the emphasis on lowering the rates relative to the emphasis on broadening the base). What is still missing, by and large, is a clear-sighted concept of the desired tax base - that is, the definition of income subject to tax.

The earlier base-broadening efforts lacked such a clear objective, and consequently they added patches to an existing crazy quilt. In that setting each patch is the potential subject of a political struggle, and if there is no clear reason why one side of the struggle should prevail in the general interest, there is no hope for imposing rationality on the law as a whole.

It would, of course, be naive to assert that having a well thought through goal of income tax policy is an absolute guarantee against erosion of a tax base by deductions and credits inconsistent with that goal. I do believe, though, that without a clear strategy we cannot hope to avoid mounting complexity, with attendant distortions and taxpayer dissatisfaction.

In contemplating changes it is important to recognize that a tax law does not consist simply of the statute enacted by the Congress. It includes as well the great web of regulations, rulings and the like that translate the statute into practice. Regardless of how short or simple its wording, a statute lacking a consistent rationale cannot be simple and equitable in practice. What could illustrate this better than a statute establishing a tax on "income from whatever source" but failing to provide an economically consistent definition of income to guide implementation.

"Economic consistency" prevails when the tax consequences of two economically equivalent events are the same. Let me give an example or two of the lack of economic consistency in our present tax law:

Consider a taxpayer in the fifty percent marginal rate bracket with $1,000 to invest for his retirement in 25 years. If he puts his money into a money market fund yielding, let us say, 15 percent, and withdraws enough each year to pay the income tax due on his interest, at the end of twenty-five years his $1,000 will have grown to $6,521. Suppose instead he can find an asset with the same rate of return but for which the yield comes in the form of capital gain. The situation is economically equivalent to the one first described. But he will pay no tax at all until the end of twenty-five years, at which point the gain is realized to finance retirement consumption. After paying tax at long-term capital gains rates, in the second case he will have $34,217 instead of $6,521. Even without the favorable tax treatment of long-term relative to short-term gains the advantage of deferral would mean the second approach would yield him $21,761 instead of $6,521.

Suppose, to carry the example a step further, our taxpayer elected to borrow $1,000 (at 15 percent) to add to his own $1,000, so he could purchase more of the capital gain asset. Now he would have interest deductions each year. To make the comparison easier, suppose he borrows enough extra each year to pay the interest net of his

annual tax savings, with all the debt to be repaid at the twenty-five year point. Once again, in the absence of taxes, his real situation would be the same as in the previous examples: he sets aside $1,000 of his own money in the first year, reaping any return twenty-five years later. But now, the combination of the favorable treatment of long-term capital gains, the deferral of tax on accruing gains, and the deduction of interest provides him with $61,913 instead of $6,521. (This example is particularly interesting as it shows how the tax system may even improve the yield on the wealth of the higher bracket taxpayer. Here his proceeds after twenty-five years exceed the $42,521 he would have obtained in the absence of any tax on interest or capital gains.) Finally note that even without the favorable long-term capital gains rate, our investor would have $37,001 after twenty-five years under the scheme with borrowing.

These illustrations of inconsistencies in existing income tax law could easily be multiplied. Inconsistencies may be of many kinds. For example, there are many distinctions made between employee compensation received in the form of cash and that received in the form of various fringe benefits which make little economic sense. But the most mischievous cases have to deal with transactions over time. These are essentially differences in the tax treatment of the economic equivalents of borrowing and lending. To exploit them the taxpayer does not have to change his occupation or life style, just his portfolio.

It seems obvious that reduced tax rates will mean inconsistencies are also reduced in significance. However, unless the rates are dramatically lower, the importance of careful structuring of the rules will not be diminished. To illustrate, suppose the tax rate in the examples above were 25 percent instead of 50 percent, and there were no preferential rate applicable to long-term capital gain, although capital gains continued to be taxed on a realization rather than accrual basis. Then our ordinary saver would reap $16,651 from his $1,000; the taxpayer putting his money in the capital gain asset, $32,141; the one matching his $1,000 in the capital gain asset with $1,000 of borrowed funds, $47,631. Cutting the rate in half has lowered the relative advantage of the third strategy but actually increased the dollar advantage, even relative to the situation in which long term gains are taxed at 40 percent of the regular rate.

The dramatic quality of these particular examples depends upon the high rate of interest I have assumed. Clearly a rate of interest of 15 percent is extremely high by historical standards. Current yields at that level are a phenomenon of the inflationary times. We have many lessons to learn from the effect of inflation on the tax system, a point I shall return to below. For now, the points to stress are:

(1) Taxpayers may have enormous incentive to seek out and exploit inconsistencies in the tax treatment of saving and investment.

(2) While lower rates of tax will tend to reduce many distortions, they will not eliminate them, and they may leave surprisingly large distortionary incentives.

(3) It takes careful thought to design a tax system having a high degree of consistency, expecially one that can be administered by ordinary human beings.

In the realm of possible individualized taxes, that is, taxes whose rates can be varied to reflect individual circumstances, there are basically two serious contenders. One is grounded in the notion of income as the sum of consumption and saving during the year, taken as a measure of taxpayer well-being. The second, in the category of consumption taxes, is grounded in the taxpayer's longer term consumption power. Either of these can in principle be adopted as the "clear objective" of which I have spoken.

It was my good fortune during a period of service in the Treasury Department to direct a staff study to see what really could be done to broaden the base and lower the rates through very careful application of these alternative principles. The report of that study was published by the Treasury Department in January 1977, under the title, Blueprints for Basic Tax Reform. In my no doubt biased view, that report should be required reading for tax policy makers. In any case it contains materials relevant to evaluating the flat-tax proposals which are our concern today.

Blueprints presents two illustrative tax plans, designed to replace our present income tax on both individuals and corporations. The first plan is called the Comprehensive Income Tax, and implements the theoretical idea of income as the sum of all consumption and saving during the year. The second plan is called the Cash Flow Tax and implements the theoretical idea of taxing on the basis of the individual's long-term level of consumption.

In concept the Cash Flow Tax differs from the Comprehensive Income Tax in exempting the returns to saving. It says to the taxpayer, if you decide to put money aside to consume in the future we won't increase your tax burden. It turns out that this difference in concept allows an enormous difference in simplicity of implementation.

There are two ways to implement the exemption of savings. The first uses the approach now taken with respect to qualified retirement savings: amounts set aside are deducted from the tax base, and subsequent pay-out is included in the base. The second simply ignores both the input and the output sides of saving. No deduction is made for the amount saved, and the subsequent return is not taxed. If we think of the

tax as assessed on consumption, the second approach amounts to prepayment of tax. Implementation of what I call the long-term consumption level approach to taxation can take advantage of these two techniques. The result is a very simple set of rules, which essentially involve only keeping track of cash flows. This is the origin of the name of the system in Blueprints called the Cash Flow Tax.

The bulk of the Blueprints report is devoted to explaining the tax concepts, including details on a great variety of specific issues (e.g., how to tax earnings on life insurance; how to implement integration of corporation and shareholder accounts; what personal deductions make sense; how should second earners be taxed). One chapter is devoted to quantitative estimates of the distribution of existing income tax burdens. In that context, the report develops structures of exemptions and rates applicable to the broadened and rationalized bases, and designed to approximate the then existing pattern of tax burdens.

The quantitative estimates in Blueprints are, of course, just that, estimates. However, they were carefully done and should not be very far from the true picture. Table 1 presents figures, derived from the Blueprints data, on effective tax rates. By "effective tax rate" in this case is meant the ratio of each household's actual burden to that household's broad-base income. There are thus two sets of rates corresponding to the different denominators of the effective tax rate calculation, and these rates are in turn developed to represent the burdens under two different tax laws. The columns labeled "1976 law" are taken from Blueprints, and reflect the burdens of the individual and corporation tax rules then in effect. (The classifiers have been inflated to express the income categories in 1984 dollars).

The columns labeled "1984 law" express my guess about what has happened to the law since 1976. The 1984 law columns are obtained from the 1976 law figures by allowing for the drop in rates, bracket creep and the effect of inflation on personal exemptions. (Overall the individual income tax law of 1984 will raise more revenue in real terms than would the law of 1976 adjusted for inflation - a commentary on the "tax cuts" of recent years.)

Even if only rough approximations, the figures are quite informative. It is immediately clear from them that the income tax system as a whole, for all of its inconsistencies and loopholes, is quite progressive. The burdens it imposes increase with income and the increase is more than proportional. That is, the ratio of tax burden to either measure of taxpayer well-being rises with the level of the measure. Second, a single proportional rate applied to one of the broad bases, or any closely related broad base, will certainly involve big changes in the distribution of tax burdens. Blueprints estimates that a rate of 14.35% applied to the Comprehensive Income Base (or 15.73% applied to the Cash Flow Base) would have been sufficient to raise the revenue generated by the income taxes on individuals and

Table 1

Effective Rates of Combined Individual and Corporation Income Tax

Comprehensive Income Base class ($000 (1984))	Effective tax rate: 1976 law (..percent..)	Effective tax rate: 1984 law (..percent..)	Cash Flow Base class ($000 (1984))	Effective tax rate: 1976 law (..percent..)	Effective tax rate: 1984 law (..percent..)
Less than 0	-0.6	-0.6	Less than 0	0	0
0 - 9	1.7	3.4	0 - 9	2.2	4.4
9 - 18	6.4	10.6	9 - 18	7.4	12.2
18 - 27	9.9	12.9	18 - 27	11.8	15.3
27 - 35	12.7	14.0	27 - 35	14.8	16.3
35 - 53	15.4	15.4	35 - 53	18.0	18.0
53 - 88	19.8	19.8	53 - 88	23.6	23.6
88 - 177	25.2	22.7	88 - 177	30.7	27.6
177 or more	32.4	25.9	177 or more	36.0	28.8

corporations in effect in 1976. As Table 1 makes clear, such a flat rate would imply very large reductions in taxes for the well-to-do and very large increases for the less well-off.

Some, perhaps most, flat rate tax plans now under discussion provide for progressivity through the use of exempt amounts of income. We cannot read off from Table 1 the structure of exemptions that would allow a reasonable approximation to the existing tax burdens. If it is desired to maintain a degree of progressivity like that at present, the flat marginal rate must be reasonably close to the average rate on the highest income class. One might, for example, approximate the Cash Flow effective rate results for 1984 law by a flat-rate tax of roughly 30 percent, with exemptions of something like $3,600 per tax return plus $3,600 per taxpayer plus $1,800 per dependent (in 1984 dollars). This would probably mean a tax cut for those with very little cash flow income, an increase for those in the middle, and some decrease for the highest cash flow income recipients.

The implied effective tax rates for taxpayers in various filing circumstances at various Cash Flow base levels are shown in Table 2. A rough sense of how well this flat rate tax approximates the existing one may be obtained by comparing the figures in Table 2 with those in the last column of Table 1.

I draw two lessons from exercises with the Blueprints data. First, a flat-rate tax system could be constructed, to replace the existing corporation and individual taxes, that is not greatly different in overall progressivity from the exisiting system. My illustrative calculations are far from conclusive, but I would guess that for a reasonable approximation to the present progressivity that flat rate would have to be somewhat higher than the levels I have seen discussed. A flat rate tax will almost certainly involve an increase in burden on the middle income households and a reduction in burden on the lowest and perhaps highest income households. The marginal rate that will be read off the tax return will be much higher for many households than it is at present. The highest marginal rates, ranging up to 50 percent, will, of course, be eliminated.

Second, and not yet emphasized here, any shift to a flat tax will involve very great redistributions of tax burdens. Many taxpayers will bear markedly higher or lower taxes after than before a change to a flat rate scheme. We should keep in mind, of course, that the data used in the Blueprints study were in part a response to the structure then existing. Many households have mortgage interest deductions, for example, because the tax system makes home-owning attractive. A finding that homeowners' taxes will be raised relative to renters' would then have to be tempered by the fact that a change in the tax system reducing the incentive to own homes would reduce the number of homeowners as well. The response of taxpayers to changes in the rules will tend to reduce the distributional significance of the change.

Table 2

Effective Tax Rates Under Illustrative Flat Rate Tax*

Cash Flow Base	Filing Status				
	Single	Joint (number of dependents)			
		0	1	2	3
($000)	(.....present.....)				
5	0.0	0.0	0.0	0.0	0.0
10	8.4	0.0	0.0	0.0	0.0
15	15.6	8.4	4.8	1.2	0.0
20	19.2	13.8	11.1	8.4	5.7
50	25.7	23.5	22.4	21.4	20.3
100	27.8	26.8	26.2	25.7	25.1
1,000	29.8	29.7	29.6	29.6	29.5

*Tax is 30 percent of excess over $3,600 plus $3,600 for each taxpayer plus $1,800 for each dependent, not including spouse.

Still a shift to a flat-rate tax will clearly effect large redistributions, and we may well ask whether those redistributions could be reduced by applying a graduated rate structure instead of a flat rate to the expanded base. The Blueprints study concluded this to be the case. Table 3 translates into 1982 dollars the structure of rates that the Blueprints report suggested to approximate the tax burden distributions existing at that time. Were we to use the 1984 standard, the top rate would be lower and the structure of exemptions and other rates would be rearranged to take more in tax from lower and middle income households.

It is a general principle that allowing greater freedom in the design (for example three rates instead of one) will permit a closer approximation to any given tax objective. In this case the objective was to match tax burdens under existing law. Nevertheless, analysis of redistributions contained in the Blueprints report suggests that even with a relatively flexible structure, and making allowances for the limitations of the analysis, considerable changes in tax burdens would be effected in a move from current law to either reform plan. The question is, is the game worth the candle?

In replying with a qualified yes, I would like to return to my opening theme of the need for a clear cut strategy of taxation. The advantages of broadening the base will be few if it is not at the same time a move towards simplicity and consistency in the law. And to this end, my view has increasingly become, the clearly dominating approach is that of the Cash Flow Tax.

I would be glad to discuss today the reasons a strategy of taxing on the basis of long-term consumption level, as is implemented by the Cash Flow Tax, is preferable to a strategy based on the classic notion of annual income, as is implemented by the Comprehensive Income Tax. It seems to me the consumption approach has the advantage on all the three usual criteria: equity, efficiency, and simplicity. But time is short, and the aspect I would like to stress now is the enormous simplicity advantage of the Cash Flow Tax.

In brief outline a taxpayer's Cash Flow is the sum of cash compensation, pension benefits and other transfers, gifts and inheritance received, gross receipts from unincorporated businesses, and withdrawals from "qualified accounts" (like present IRA's) less contributions to qualified accounts (including qualified retirement accounts), all business outlays (including capital outlays), and gifts or bequests to another taxpayer. (Deductions for such items as charitable contributions and state and local income taxes could be allowed or not as a matter of policy.) Such items as interest and dividends received and proceeds from the sale of assets are not included, nor are deductions allowed for interest paid, depreciation or the cost of assets sold. The resulting total can be taxed either at graduated rates as now, or at a flat rate above an exemption.

Table 3

Blueprints Rate Structures*

Comprehensive Income Tax		Cash Flow Tax	
Basic exemption: $3,010 per return plus $1,881 for each taxpayer and dependent		Basic exemption: $2,822 per return plus $1,505 for each taxpayer and dependent	
Comprehensive Income bracket (dollars)	Marginal tax rate (percent)	Cash Flow bracket (dollars)	Marginal tax rate (percent)
Joint returns:		Joint returns:	
0 - 8,654	8	0 - 9,784	10
8,654 - 75,258	25	9,784 - 56,443	28
over 75,258	38	over 56,443	40
Single returns:		Single returns:	
0 - 5,268	8	0 - 6,020	10
5,268 - 75,258	22.5	6,020 - 56,443	26
over 75,258	38	over 56,443	40

*Adjusted for inflation from 1976 to 1984. These rates, together with special rules for secondary workers, were designed to yield approximately the same distribution of tax burdens as was generated by 1976 law.

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Table 4 goes into more detail on the items included and deducted under versions of the Cash Flow Tax and the Comprehensive Income Tax. I have carried these labels over from Blueprints, even though the rules described in Table 4 differ in minor ways from Blueprints. The Comprehensive Income tax is included in the table for its own interest and for purposes of illustrating the simplicity advantage of the Cash Flow Tax.

In setting out the systems described in Table 4 I have tried to be as rigouous as possible in adhering to the underlining ideas of, on the one hand, taxing, consumption plus accumulation of wealth during the year (the Comprehensive Income Tax) and, on the other, taxing the households' long-run consuming power (the Cash Flow Tax). It will be readily seen from the number of double "yeses," there is a great deal in common between the two tax systems. The instances in which important transactions are treated differently have been highlighted by asterisks in the table.

What is striking to anyone who knows how tax laws are actually administered is how many problem areas in Table 4 are confined to the Comprehensive Income Tax alone. Again, I must be selective. Let me single out three instances for brief elaboration. (I would be happy to respond to questions about any aspect of Table 4.)

The three transactions illustrating my point are interest received or paid on financial assets (receipts items R-4, deduction item D-4), integration of corporation and shareholder income accounts (R-6), and capital gains (R-8 and D-8). These are important instances of differences between the Comprehensive Income Tax and the Cash Flow Tax. I shall discuss them in reverse order.

Inclusion item R-8 and deduction item D-8 together accomplish the taxation of capital gains in the Comprehensive Income Tax. Ideally, a taxpayer who enjoys an increase in the value of an asset he owns during the year should be taxed on that increase under an income tax. And conversely, if an asset declines in value, a corresponding reduction should be made in the taxpayers' income accounts. However, it is generally felt that estimating the accrual of such gains and losses is beyond the reach of practical accounting. Consequently, the procedure of recognizing capital gains and losses only on realization through sale or exchange has been accepted in our actual tax law and, most reluctantly, in the illustrative Comprehensive Income Tax.

As any seasoned tax law professor can testify the realization basis for accounting has endless mischievous consequences in an economy in which the economic reality of concern to taxpayers is the accrual of gains and losses. We have seen above the large rewards of deferral accorded to capital gains assets as a result of realization accounting. Furthermore, the opposite sort of advantage obtains in the case of capital losses. A policy of realizing losses and postponing gains is standard operating procedure for investors under

Table 4

Information on Tax Returns for Illustrative Comprehensive Income and Cash Flow Taxes

(Items preceded by an asterisk are treated differently under the Comprehensive Income Tax and the Cash Flow Tax.)

Household receipts and Deductions		An Element of C.I.T.	An Element of C.F.T.
Receipts:			
R-1	Wages, salaries, royalties, etc., subject to tax.[1]	Yes	Yes
R-2	Receipts of pensions, annuities, disability compensation, unemployment compensation, workmen's compensation, and sick pay.[2]	Yes	Yes
*R-3	Gifts, inheritances, trust distributions, and life insurance death benefits received.[3]	No	Yes
*R-4	Interest received on financial assets, adjusted for inflation.	Yes	No[4]
R-5	Dividends received on corporate earnings.	No[5]	No[6]
*R-6	Allocated share of inflation corrected corporate earnings.	Yes	No
*R-7	Policyholder claim on earnings from life insurance, annuity, and pension plan reserves adjusted for inflation.	Yes	No
*R-8	Increase in value of the claim on a trust, beyond allocated share of amounts given or bequeathed to the trust, adjusted for inflation.	Yes	No
*R-9	Proceeds from the sale, exchange or distribution of capital assets.	Yes	No[4,6]
*R-10	Imputed service value attributable to owner-occupied housing and other household durables.	Yes	No
R-11	Gross receipts from unincorporated business enterprises.	Yes	Yes
*R-12	Withdrawals from qualified accounts (including withdrawals of borrowed funds).[7]	No	Yes
R-13	Total receipts (sum of included items R-1 through R-12).		

Table 4 Continued

Household receipts and Deductions		An Element of C.I.T.	An Element of C.F.T.
Deductions:			
D-1	Special items as a matter of policy (e.g., charitable contributions, medical expenses).	Yes	Yes
D-2	Contributions to qualified retirement plans.	Yes	Yes
*D-3	Gifts and bequests made to an identified taxpayer or trust with eligible beneficiary (cf. receipts item R-3).	No	Yes
*D-4	Interest paid on indebtedness (including interest on home mortgages), adjusted for inflation.	Yes	No[8]
*D-5	Net life insurance premiums.	No	Yes
D-6	Employee business expense (includes qualified travel expenses, union and professional association dues, tools, materials and qualified educational expenses).	Yes	Yes
*D-7	Basis of assets sold, exchanged or distributed (cf. receipts item R-9), adjusted for inflation.	Yes[9]	No
D-8	Current expenses associated with unincorporated business enterprises.	Yes	Yes
*D-9	Capital outlays associated with unincorporated business enterprises.	No	Yes
*D-10	Depreciation allowances for current and past capital outlays associated with unincorporated business enterprises, adjusted for inflation.	Yes	No
*D-11	Deposits to qualified accounts (including repayment of borrowed funds).	No	Yes
D-12	Total deductions (sum of included items D-1 through D-12).		
Tax Base:			
B-1	Total receipts less total deductions (R-13 minus D-12).		

Footnotes to Table 4

1 The definition of "wages subject to tax" could incorporate differential rules according to individual characteristics (for example, marital status might be used to mitigate the "marriage tax" problem). This item would exclude social security taxes attributable to retirement benefits and contributions to retirement plans. It would include employer-paid health and insurance premiums and similar employee benefit outlays.

2 This item would probably include social security benefits of all types. Pensions and annuities for which there has been no exclusion under R-1 or deduction under D-2 or D-11 would be excluded under R-3.

3 The exclusion of gifts and inheritances received under the illustrative Comprehensive Tax may be rationalized by the difficulty in measuring accruing wealth from anticipated inheritance. Correspondingly, the giver, bequeather, or life insurer receives no deduction from the Comprehensive Income Tax base (deduction items D-3 and D-5). Alternatively, with appropriate modification of the treatment of life insurance and trusts, the Comprehensive Income Tax could follow the illustrative Cash Flow Tax usuage, and vice versa.

4 Under the illustrative Cash Flow Tax a significant distinction is made between assets owned on a "tax prepaid" basis, the return on which is excluded from the base, and assets owned via qualified accounts, the return on which is ultimately included in the base when withdrawn. See footnote 7 below.

5 The exclusion of dividends under the Comprehensive Income Tax is a corollary of the allocation of all corporate income to shareholders. Dividends result in a reduction in the "basis" of the shares for purposes of calculating gain from sale or exchange (capital gain).

6 Under the Cash Flow Tax qualified account treatment would be obligatory for closely held corporations. See footnote 7 below.

7 "Qualified accounts," which are similar to IRA's and H.R. 10 Accounts in current U.S. income tax law, play a critical role in the cash flow tax. All inflows are deducted from the tax base, and all outflows are included. Nothing transpiring inside the account has direct tax consequences.

8 Borrowing via qualified account (cf. fn. 7) is included in the tax base and all consequent payments into the account, whether of principal or interest, are deducted. However, neither interest on nor repayment of borrowing outside of a qualified account has tax consequences under the Cash Flow Tax.

9 The deduction of adjusted basis would have to be limited, as at present, in relation to sales proceeds in R-9. Unused deduction of net losses could be carried forward.

existing law. It is difficult to exaggerate the complexity a realization approach to income accounting introduces to the law as it affects the conduct of business affairs of any significance.

Next notice that innocuous phrase, "adjusted for inflation." In a remarkable study a few years ago, Martin Feldstein and Joel Slemrod analyzed the capital gains on corporate stock reported by taxpayers on their returns for 1975. Feldstein and Slemrod found that while in the aggregate there was reported a gain of $6 billion, if the basis of the shares had been corrected for the change in the price level between the time of acquisition and the sale of the shares, the amounts would have actually aggregated to a loss of $1 billion. If the tax system is to be based on real rather than purely nominal quantities, adjustment of capital gains basis for inflation is an essential, even if unpleasant complication.

Finally on the subject of capital gains, I would note the challenge it poses to fair and effective administration. Simply keeping track of sales, exchanges, and the basis of assets presents great administrative problems, both to the tax authorities and to taxpayers.

The illustrative Cash Flow Tax allows a taxpayer alternative ways to account for assets purchased or sold. On the one hand, there is the option to obtain assets through qualified accounts (see footnote 7 to Table 4). Outlays to purchase assets in this form are deducted from the tax base and proceeds of the sale of assets withdrawn for consumption are added to the tax base via the recorded addition or withdrawals from qualified accounts. The sale of an asset for which no deduction has been taken would have no tax consequences at all. No inflation adjustment would be necessary under either of these approaches.

Let me turn now to a discussion of the taxation of corporate earnings. Under a full-fledged accrual tax system, the change in value of an equity owner's shares in a corporation during the course of the year would be treated as income subject to tax. As we lack such an accounting system, if distortions (of the sort discussed earlier in connection with capital gains) are to be avoided, it is essential to have some method of attributing corporate earnings to shareholders. This is the well known problem of integrating the accounts of corporations and their shareholders. Receipts item R-6 notes the necessity of including such an allocation in the Comprehensive Income Tax.

Again, the unpleasant problem of adjusting for inflation is present. Tax legislators know well what inflation does to corporate tax accounts - the chaotic state of accelerated depreciation allowances and investment credits, the mixture of LIFO and FIFO inventory accounting systems, and many other features of current economic life are attributable in large measure to inflation. There simply is no

well understood, well accepted method of accounting for corporate earnings in a time of inflation, and yet it is essential that taxes be based on real and not purely nominal profits.

Then there is the problem of allocating those profits to the shareholders. Blueprints, indeed, presents an innovative method for accomplishing this task of integration. However, it would not be widely regarded as terribly simple and it certainly reflects a difficult change from current practice.

Under the Cash Flow tax, it is unnecessary to allocate the earnings of corporations to shareholders.

Under an income tax it is normal to measure gain on amounts loaned by the taxpayer by treating the interest received as income, and to measure the sacrifice of consumption or wealth incurred by a borrower by allowing a deduction for interest paid. In a time of inflation, however, this measurement method may be wildly inaccurate. This is a matter which is still all too little understood and yet extraordinarily important.

Inflation produces an "inflation premium" in interest rates. Unfortunately, it is not easy to determine what that premium is, since it depends upon hard-to-observe anticipations of future price level changes. But failure to adjust interest payments and receipts can produce astounding distortions of incentives when the inflation rate is large. To illustrate, take the case in which the interest rate in the absence of inflation is 2 percent, and suppose that with an inflation rate of 13 percent an interest rate of 15 percent prevails. Consider now the price today for which a dollar of real purchasing power 25 years hence can be bought by lending (or sold by borrowing) at compound interest. Column 1 of Table 5 shows how the price varies with the tax rate on interest in the absence of inflation. Thus, for example, if interest is taxed at 30 percent, the saver receives a net of tax interest of 70 percent of 2 percent, or 1.4 percent per annum. According to Table 5, $.70, invested at 1.4 percent, will grow to $1 in 25 years.

The figures in column 1 also apply in the case of inflation if interest payments and receipts are adjusted for tax purposes by subtracting out the 13 percent inflation premium. Thus, while nominal dollar amounts after 25 years are much larger, the real purchasing power obtained is the same as with no inflation.

Column 2 of Table 5 shows the price without inflation adjustment. Prices in excess of $1 in column 2, which occur for all tax rates shown above zero, reflect the fact that, in the absence of inflation adjustment, the after-tax rate of interest is negative under the illustrative conditions. For example, a saver in the 50 percent bracket receives 7.5 percent per annum after taxes, in nominal terms.

Table 5

Illustration of the Effect of Inflation on the Price (via Borrowing or Lending) of a Dollar Purchasing Power 25 Years Hence

Individual tax rate on interest	No inflation or inflation plus adjustment of interest for tax purposes	13 percent annual inflation and no adjustment
(percent)	(.....dollars.....)	
0	.61	.61
15	.65	1.06
30	.70	1.87
50	.78	3.96

*Entries show the present amount one would have to set aside at compound interest to obtain one dollar (in present purchasing power) 25 years hence. In the illustration the interest rate with no inflation is assumed to be 2 percent; with inflation at 13 percent the interest rate is assumed to be 15 percent.

This implies an annual loss in purchasing power on the amount loaned of 5.5 percent per annum. Small wonder that high bracket taxpayers are heavy borrowers, rather than lenders, under those terms. An individual with a tax rate of any significance suffers an extraordinary reduction in the incentive to lend (and increase in incentive to borrow) in the presence of high inflation, unless an adjustment is made in the taxation of interest received or the deduction of interest paid. Unfortunately, while this adjustment is a necessary part of a consistent income tax, its implementation is far from simple.

The Cash Flow Tax requires no special adjustment of interest for inflation, since interest paid or received outside of qualified accounts is totally ignored for tax purposes. Interest paid or received via qualified accounts is simply part of the total return, taxed on withdrawal and credited on deposit, on a cash flow basis. No inflation adjustment is necessary as far as measurement of the tax base is concerned.

These are important instances, in which the Cash Flow Tax provides very simple rules whereas the Comprehensive Income Tax presents formidable implementation difficulties. Many others can be found in Table 4.

Let me conclude with one or two remarks about prospects for action.

Of the various broaden-the-base, lower-the-rates schemes under current discussion, two, I believe, display different aspects of the virtues discussed today. These are the desirability of avoiding extreme redistributions of tax burdens, at least in any short period, and the desirability of tax rules which display a high degree of economic consistency.

The Bradley-Gephardt bill displays the first virtue. Careful staff work has gone into developing rules which will maintain a distribution of tax burdens rather similar to that presently obtaining, at least taking into account the individual income tax alone. Of course, it is not a "flat-rate" tax; rather, it is a graduated rate tax of the sort we presently have. However, it does succeed in substantially reducing tax rates, thereby reducing some of the distortions currently prevailing. (Note, though, as the discussion of capital gains at the beginning indicates, merely reducing rates may not eliminate distortions.) The Bradley-Gephardt Bill fails, however, to carry out a highly consistent tax strategy. Thus it includes a proposal to tax pension savings at a flat rate, independently of the

circumstances of the saver. It makes no effort to integrate corporation and individual income accounts. It makes no provision for adjustment of the measurement of income for effects of inflation. In short, while I am sympathetic to the effort and respect the skill that has gone into it, I am not persuaded that as now structured it would represent a sufficient improvement upon the current system to justify the cost of making such a large change.

The Hall-Rabushka plan, by contrast, represents an ingenious effort to implement a consistent tax base along the Cash Flow Tax lines. By employing a single flat rate above an exemption, the Hall-Rabushka plan is able, indeed, to surpass the Blueprints type Cash Flow Tax in simplicity. This is accomplished by taking advantage of a flat-rate tax on businesses to tax such forms of consumption as the fringe benefits provided by employers. Unfortunately, however, the simplicity is bought at a price in terms of the upsetting of existing burden distributions. As I have suggested, my own guess is that a plan along the Hall-Rabushka lines with a tax rate much below 30% would involve a considerable redistribution of the tax burdens from the well-off to the less well-off. And even with the higher rate there would be large redistributions of tax burdens within each income level.

It may well be that a Hall-Rabushka tax at a rate of 30 percent, or perhaps even a bit higher, would nonetheless be an attractive one. I can imagine many people would be prepared to say they would gladly pay, say, 35 cents on a dollar of earnings (at the margin) in return for the clarity and simplicity that the Hall-Rabushka plan would provide.

This clarity of concept to accompany simplicity in implementation may have great political advantages. However, if the implied distribution of burdens is not attractive, it would be a mistake to give up on the basic tax strategy reflected in the Hall-Rabushka plan. As I have tried strongly to emphasize in my remarks here, the essential simplicity of it is not in its flat rate, but in its cash flow accounting. This is precisely the approach called for by a tax which is oriented to the long-term level of consumption. This I think is the only strategy that holds out any serious hope for a system that is simple, fair and defensible against erosion in the long run.

Information on Tax Returns for Illustrative Comprehensive Income and Cash Flow Taxes

(Items preceded by a bullet are treated differently under the Comprehensive Income Tax and the Cash Flow Tax.)

	Household Receipts and Deductions	An Element of C.I.T.	An Element of C.F.T.
Receipts:			
R-1	Wages, salaries, tips, royalties, etc., subject to tax.[1]	Yes	Yes
R-2	Receipts of pensions, annuities, disability compensation, workmen's compensation, and sick pay.[2]	Yes	Yes
• R-3	Gifts, inheritances,trust distributions and life insurance death benefits received.[3]	No	Yes
• R-4	Interest received on financial assets, *adjusted for inflation*	Yes	No[4]
R-5	Dividends received on corporate earnings	No[5]	No[4,5]
• R-6	Allocated share of *inflation corrected* corporate earnings.	Yes	No
• R-7	Policyholder claim on earnings from life insurance, annuity, and pension plan reserves, *adjusted for inflation*.	Yes	No
• R-8	Increase in value of the claim on a trust, beyond allocated share of amounts given or bequeathed to the trust, *adjusted for inflation*.	Yes	No
• R-9	Proceeds from the sale, exchange or distribution of capital assets.	Yes	No[4,6]
• R-10	Imputed service value attributable to owner-occupied housing and other household durables.	Yes	No
R-11	Gross receipts from unincorporated business enterprises.	Yes	Yes
• R-12	Withdrawals from qualified accounts (including withdrawals of borrowed funds).[7]	No	Yes
R-13	Total receipts (sum of included items R-1 — R-12).		
Deductions:			
D-1	Special items as a matter of policy (e.g., charitable contributions, medical expenses).	Yes	Yes
D-2	Contributions to qualified retirement plans.	Yes	Yes
• D-3	Gifts and bequests made to an identified taxpayer or trust with eligible beneficiary (cf. receipts item R-3).	No	Yes
• D-4	Interest paid on indebtedness (including interest on home mortgages), *adjusted for inflation*.	Yes	No[4]
• D-5	Net life insurance premiums.	No	Yes
D-6	Employee business expense (includes qualified travel expenses, union and professional association dues, tools, materials and qualified educational expenses).	Yes	Yes
• D-7	Basis of assets sold, exchanged or distributed (cf. receipts item R-9), *adjusted for inflation*.	Yes[8]	No
D-8	Current expenses associated with unincorporated business enterprises.	Yes	Yes
• D-9	Capital outlay associated with unincorporated business enterprises.	No	Yes
• D-10	Depreciation allowances for current and past capital outlays associated with unincorporated business enterprises, *adjusted for inflation*.	Yes	No
• D-11	Deposits to qualified accounts (including repayment of borrowed funds).	No	Yes
D-12	Total deductions (sum of included items D-1 — D-11).		
Tax Base:			
B-1	Total receipts less total deductions (R-13 minus D-12).		

[1]The definition of "wages subject to tax" could incorporate differential rules according to individual characteristics (for example, marital status might be used to mitigate the "marriage tax" problem). This item would *exclude* social security taxes attributable to retirement benefits and contributions to retirement plans. It would *include* employer-paid health and life insurance premiums, and similar employee benefit outlays.

[2]This item would probably include social security benefits of all types. Pensions and annuities for which there has been no excusion under R-1 or deduction under D-2 or D-11 would be excluded under R-3.

[3]The exclusion of gifts and inheritances received under the illustrative Comprehensive Income Tax may be rationalized by the difficulty in measuring accruing wealth from anticipated inheritance. Correspondingly, the giver, bequeather, or life insurer receives no deduction from the Comprehensive Income Tax Base (deduction items D-3 and D-5). The same system could be applied to the Cash Flow Tax. Alternatively, with appropriate modification of the treatment of life insurance and trusts, the Comprehensive Income Tax could follow the illustrative Cash Flow Tax usage, and vice versa.

[4]Under the illustrative Cash Flow Tax a significant distinction is made between assets owned on a "tax prepaid" basis, the return on which is excluded from the base, and assets owned via qualified accounts, the return on which is ultimately included in the base when withdrawn. See footnote 7 below.

[5]The exclusion of dividends under the Comprehensive Income Tax is a corollary of the allocation of all corporate income to shareholders. Dividends result in a reduction in the "basis" of the shares for purposes of calculating gain from sale or exchange (capital gain).

[6]Under the Cash Flow Tax qualified account treatment would be obligatory for closely held corporations. See footnote 7 below.

[7]"Qualified accounts," which are similar to IRA's and H.R. 10 Accounts in current U.S. income tax law, play a critical role in the cash flow tax. All inflows are deducted from the tax base, and all outflows are included. Nothing transpiring inside the account has direct tax consequences.

[8]Borrowing via qualified account (cf. fn. 7) is included in the tax base and *all* consequent return payments into the account, whether of principal or interest, are deducted. However, neither interest on nor repayment of borrowing outside of a qualified account has tax consequences under the Cash Flow Tax.

[9]The deduction of adjusted basis would have to be limited, as at present, in relation to sales proceeds in R-9. Unused deduction of net losses could be carried forward.

Representative RICHMOND [presiding]. Mr. Kurtz, it's certainly a pleasure having you here. You know Albert Lasko's slogan that he gave to the Packard Motor Co.?

Mr. KURTZ. No.

Representative RICHMOND. "Ask the man who owns one." So I get the feeling that flat rate taxes is you.

STATEMENT OF JEROME KURTZ, ATTORNEY, WASHINGTON, D.C.

Mr. KURTZ. Representative Richmond, I have a prepared statement which I assume will be incorporated in the record and I'll simply summarize some of the points here.

I think the most important point to keep in mind in talking about so-called flat rates is that the issue of simplification, broadening of the tax base, and the issue of rates, are two almost completely separate issues.

I think we all agree sitting at this table and most people in the country would agree that the tax system is having its problems. It's too complicated. It's largely viewed as unfair. Rates are thought to be too high and probably largely as a result of those three conditions, compliance seems to be falling.

Those problems are largely the result of the fact that over the years our income tax system has moved away from what the goal of the tax system ought to be, the reason we have an income tax in the first place. The reason, of course, is to measure income in terms of a person's capacity to pay tax. We're trying to find out who can afford to pay what. But over the years we've built into our tax system a complete separation in large measure unrelated expenditure system. The tax system now contains over 100 special provisions which have little to do with measuring taxpaying capacity but rather has to do with decisions that have been made to encourage or reward people for undertaking certain types of investments or for undertaking other types or other kinds of expenditures which were viewed at one time or another as socially desirable and useful and rather than encouraging those through subsidy programs or expenditure programs of one kind or another, tax relief was built in.

It cannot be said that any one of those provisions has caused extraordinary problems in the income taxes, but the accumulation of the 100 provisions like that has.

We have a tax system now that is largely un-understandable by most people who have to comply with it and the fact that the system that we have is basically a self-assessment system which relies on people assessing and computing their own tax seems to me to require that the person doing so have some understanding of how the system works and where he fits within the system. Otherwise, we have suspicion; we have people believing—a belief based in fact but exaggerated—that others are not paying their fair share, that others with the same income are paying less, that people with higher incomes are paying less; and that's true in some cases. It's not as widely true as it is perceived by most people.

This year the individual income tax will raise about $300 billion. If there were no tax expenditures, it would raise another $200 billion.

Representative RICHMOND. That's the flat rate?

Mr. KURTZ. No; that's the existing rates.

Representative RICHMOND. If there were——

Mr. KURTZ. If there were no tax expenditures——

Representative RICHMOND. What do you mean by tax expenditures?

Mr. KURTZ. Tax expenditures are those provisions in the tax law basically which do not have to do with a measurement of economic well-being, deviations between taxable income and what an accountant or an economist might define as income. For example, accelerated depreciation—depreciation deductions beyond the actual wearing out of the asset, percentage depletion, the deduction of real estate taxes by homeowners, the deduction of mortgage interest and consumer interest—and I could go on. There's a list published of about 100.

Let me say that there are debates as to whether some of those items are expenditures or whether they have to do with the measurement of income. Those debates are based largely around the edges as to certain items. By and large, those items can be well identified.

Representative RICHMOND. If there were no deductions, that would be $500 billion?

Mr. KURTZ. It would be $500 billion at existing rates. Let me say I'm not suggesting that anyone would want to do that.

Representative RICHMOND. No; I understand you.

Mr. KURTZ. I'm only using that number as a measure of the order of magnitude of those provisions.

Representative RICHMOND. Right.

Mr. KURTZ. And what I'm saying is if we had a very simple, broadly based tax, eliminating tax expenditures, we could lower rates on the order of 40 percent from where they are today because the base would be that much broader.

Representative RICHMOND. So that would be an effective average of how much? Mr. Roberts says 16 percent. Mr. Bradford says 30 percent. So what would your percent be?

Mr. KURTZ. The overall effective rate? There were figures presented at your last hearing by Joe Minarik of the Congressional Budget Office that come out that if you use present taxable income that it would take an overall rate of about 18.5 percent to match revenue collections at 1984 rate levels. That is, after the present reductions are fully in effect.

Now let me say that is an overall effective rate. That is the flat rate that it would take to match 1984 revenue collection on today's tax base.

Representative RICHMOND. Are you also excluding the low-income people completely?

Mr. KURTZ. It keeps the same exemption levels as we have today and the same zero bracket amount or standard deduction as we have today.

It should be pointed out that the tax would be collected in a vastly different way and that there would be a very great increase in lower and middle income taxpayers' burden and very significant decreases in the incomes of the highest income taxpayers. For example, according to Minarik's tables, you would have an average 56-percent tax deduction for taxpayers with over $200,000 of income from where they are today on average. Now within each income class there would be gainers and losers because obviously today there are $200,000 people who aren't paying any income taxes.

Representative RICHMOND. People living on revenue from municipals pay no taxes, right?

Mr. KURTZ. Right.

Representative RICHMOND. And under this they would have to pay 18.5 percent?

Mr. KURTZ. That's right—no, I'm sorry. Not under this. This is on today's tax base.

Representative RICHMOND. Using a flat rate system?

Mr. KURTZ. Using today's taxable income—that is, you would take the same return you file today with all the complications, and so forth, and get down to the bottom line and instead of applying the current rate structure you apply one rate. The question is: What is that rate to raise overall the same amount of revenue that you raise today?

The point that I would like to emphasize because I think it is extremely important in considering this issue that the question of simplification which involves base-broadening essentially—that is, eliminating large numbers of deductions, taxing all income the same, whether it is capital gains, and so forth—is a different issue from the rates to be applied once the base is broadened.

That is, one can vastly simplify the computation of income and still apply progressive rates to it. They are completely different issues and I might add in that regard that I think there is significant confusion that the term simplified flat rate tax is used very broadly and I think the common implication of that term is that simplification requires flat rates, or to state it another way, much of the complication in our system is a result of progressive rates. That is simply not true. There are some complications that come about from progressive rates, but they are relatively minor in terms of the problems that we have and the complexity of our existing system and we shouldn't lose sight of the fact that going to any flat rate system on any income base substantially changes the distribution of the tax burden from where it is today. It will inevitably reduce taxes significantly on the highest income people and consequently to raise the same amount of revenue will have to increase somebody else's taxes, and it is either the lower- or middle-income groups, depending on how high an exemption level and rate is created. But certainly there would be a shift downward of the tax burden regardless of the flat rate.

Representative RICHMOND. Except we know many high income people pay little or no income taxes.

Mr. KURTZ. Yes, but on average, the income tax system today is progressive, on average. That is, if you take people with a $100,000 income, $200,000 of income, they pay—if you take them as a class, on average, they pay more than those with $25,000 income as a class.

Now if you broaden the base even with progressive rates, you would then have shifts of tax burden within the income class, but you could maintain the same total collections within the class, maintain progressivity in the system, make it fairer by taxing those with equal income in an economic sense more equally, and at the same time tax those within larger incomes a greater percentage of their incomes than those with smaller incomes.

There are two other points that I would like to make. One is we've been talking so far only about the individual income tax. The individual income tax is not the only tax the individuals bear. Social security taxes, as you know, for most taxpayers in the United States is a greater burden than income taxes. Over half the taxpayers in the United States pay more social security tax than income tax if we

assume, as I think would be generally agreed, that the employer share of the tax ultimately is borne by the employee.

We will raise $300 billion this year in the individual income tax and we'll raise about $225 billion from social security taxes. Social security taxes are at a rate of 6.7 percent on employee and employer for a total of 13.4 percent, but it's from $1, no exemption. So it applies to wage earners in the poverty level. It cuts off $32,400 which means as a percentage of total income it's regressive over $32,000 and applies only to wages. It doesn't apply to investment income of any type.

If you take the social security taxes and the individual income taxes together, we find we have a tax system today which is roughly flat, roughly proportionate, because we have a regressive social security tax and a progressive income tax which together result in a proximate flat rate, the point being that it takes progressive income taxes to keep the overall tax burden from being regressive and whatever one may say in the debate about the advantages or the fairness of progressive taxes compared to proportionate taxes, I don't think anyone advocates regressive taxes as being fair and flat rates, as a substitute for the progressive income tax would leave us individual tax burdens which are rather steeply regressive.

Representative RICHMOND. What's your solution?

Mr. KURTZ. My solution would be to substantially broaden the base of the individual income tax by eliminating most of the deductions. I might say as an aside, I don't think that could be done overnight. The commitments and market conditions and other things have built a lot of those deductions into pricing and in many instances it would have to be done gradually, but I think that ought to be the goal. Substantially broaden the tax base, try to get back to something that more accurately measures taxpaying ability, and then apply to it progressive rates which would overall be much lower than today's rates and could have much broader brackets and the result would be a system which would be virtually as simple as any of the flat rate proposals but would be a much fairer system in the view of most taxpayers.

I might just add that, as I said at the beginning, we have a voluntary compliance system, a critical element of which is most taxpayers believe that the system is fair. It's hard to gain compliance to a system that people view as unfair and whatever one may say philosophically or ethically about a regressive or progressive or proportionate tax system, it's clear to me that most people in this country believe progressive taxes are fair. Therefore, it seems to me changing to a proportionate income tax, a flat rate, would strike most people as being grossly unfair and I believe would interfere with the efficient administration of an individual income tax system.

Representative RICHMOND. How would most people feel if we closed most deductions?

Mr. KURTZ. I think most people would feel that the fairness of the system was vastly improved and it would again become possible for people to understand what the tax system is all about and how it works.

Representative RICHMOND. Are you familiar with the share the burden budget that Representative Reuss and I put together?

Mr. KURTZ. Share the burden?

Representative RICHMOND. It's called share the burden budget.

Mr. KURTZ. I'm sorry, I'm not.

Representative RICHMOND. It's a budget we tried very, very hard to develop some interest in Congress in the share the burden budget. We didn't succeed.

What it did basically was cancel most deductions. In other words, the whole concept was that the people who used Government services should pay for them. We made private planes pay airport landing fees. We made people who used the Coast Guard with these long yachts pay for Coast Guard services. We increased the highway trust fund, which as you know hasn't been increased since 1954, by 10 cents a gallon. That would give us enough money to put the highways in the United States back in shape. We repealed interest deductibility on consumer credit.

All these things were just to simplify the tax code and make it a little more fair. That saved $50 billion a year and we couldn't get anyone interested. Some people liked one piece, some people liked another piece, but as soon as you touched their particular interest—the Members of Congress from Arizona loved the share the burden budget until they saw the airport user fee. They said, "Oh, we can't do that because so many of our constituents own private planes."

Mr. KURTZ. Well, I might say as a general matter—and I'm sure you're much more familiar with the pressures than I am—the problem has been that there is no organized general constituency for tax reform or tax simplification. There are a lot of people out there who feel it, but there's no organization in any way.

Representative RICHMOND. Something like the food stamp program because there's no organized constituency.

Mr. KURTZ. And yet there is an organized constituency or one quickly comes into being for any particular deduction.

Representative RICHMOND. Sure.

Mr. KURTZ. Because it's a question of high rewards versus low rewards. That is, as you point out, if you raise the airport fees, people with private planes will have significant increases. The offset to the other 100 million taxpayers would be relatively small for return and the voice you hear is the one of the most affected.

Representative RICHMOND. Effectively, right now, every, single person in this room is paying for "Mr. Big's" Learjet to land at the airport and "Mr. Big's" 100-foot yacht to be towed in by the Coast Guard and for somebody's Rolls-Royce to be paid out on credit as so many of our wealthy Californians do.

Mr. KURTZ. I agree.

Representative RICHMOND. Why should second and third and fourth houses have mortgages which are tax deductible? Sure I can see your first car and your first house having deductibility. But why should anythings besides your first car and your first house be deductible? Why should we folks in this room have to help pay for somebody else's house in Palm Beach for which they just paid $200 million on credit?

Mr. KURTZ. You have no argument from this seat, Congressman Richmond.

Representative RICHMOND. How are we ever going to get these things changed. They are so obviously wrong and they would raise an extra $50 billion a year. Here we raise a big fuss about raising $99 billion over 3 years in this great tax bill. The share-the-burden tax bill hurts no one and raises $50 billion a year.

Yes, Congressman Reuss and I couldn't find anybody interested. In theory, they loved it.

Mr. KURTZ. I'm not surprised. On the other hand, I suppose the only hope—and I have been around long enough not to be optimistic about it—is that in combining the elimination of substantial amounts of deductions and broadening the base you could show very significant rate reductions, significant enough that people may care about them.

Representative RICHMOND. Mr. Kurtz, does any country in Europe have a tax system that's better than ours?

Mr. KURTZ. That's better?

Representative RICHMOND. Or does any country in the world have a tax system which you consider more equitable or better than ours?

Mr. KURTZ. That's a very hard question. None comes to mind immediately. The closest tax system to ours which may have some advantages in some respects is the Canadian system which seems to work pretty well. But, no, I'm not sure anyone has one that's better.

The problems that we have with our own tax system—and that is the pressure of the special interest groups to carve their particular exception out of the Tax Code—are pressures that are felt in virtually every country of the world. It's amazing, when I was with the Internal Revenue Service and would meet with foreign tax——

Representative RICHMOND. You weren't with the Internal Revenue Service; you were the Internal Revenue Service.

Mr. KURTZ. Not alone, not alone. But you talk to tax administrators from other countries and it's amazing that the problems that we all faced were pretty much the same.

Representative RICHMOND. What about the value added tax which seems to be something used in many other countries?

Mr. KURTZ. Well, the basic problem I see with the value added tax is that it's unfair.

Representative RICHMOND. Why?

Mr. KURTZ. Because again, it's highly regressive. It's a tax based on consumption. Poor people spend a higher percentage of their income than rich people, so the tax is regressive. It can be fixed up a little bit by exempting some of the necessities—food and things of that kind—which I might say, once one starts to do that, the tax becomes very complicated. People have said that the value added tax is very simple. I don't think you will find any tax administrator who administers a value added tax in agreement with that statement. It is very complicated.

Representative RICHMOND. You could exempt food, but you could hardly exempt a lobster and crab and sirloin steak.

Mr. KURTZ. That's one of the problems. If you would see the cases in the United Kingdom, for example, of trying to decide whether candy is a good or whether—and there are hundreds and hundreds of those cases. There's more effort spent on the value added tax in the United Kingdom today than the income tax today in terms of resolving disputes.

Representative RICHMOND. So that's no solution.

Mr. KURTZ. Compliance is not good with a value added tax. The assumption is that it's very high, but the greatest compliance problem we have with the income tax is with small business, and it's small business that collects a lot of the value added tax. So that the problems with lack of compliance fall in the same area.

Representative RICHMOND. One last question. Mr. Kurtz, you indicated that the underground economy is not as severe as we think it is. As you know, Congressman D'Amours has got a large, large block of Members of Congress who are against this withholding of dividends, the 10 percent, that we're voting on this afternoon.

Mr. KURTZ. Yes.

Representative RICHMOND. He agrees with you that most people should declare their dividends.

Mr. KURTZ. No, no, I don't——

Representative RICHMOND. Congressman D'Amours feels that that 10-percent withholding is unrealistic and it's going to cost more to set up the mechanics of the thing than we'll get out of it.

Mr. KURTZ. I don't agree with that at all.

Representative RICHMOND. I don't either.

Mr. KURTZ. I think the 10-percent withholding tax on interest on dividends is a great step forward. It's been advocated for 20 or 25 years. It is not expensive to install considering that we already have information reporting and I have talked to corporations who have gotten quotes on what it would cost a transfer agent to administer and they are nominal. They are really nominal. And let me say, my disagreement with the current estimate——

Representative RICHMOND. It's only a one-shot deal for the U.S. Government, of course.

Mr. KURTZ. No, no. There is a one-shot element in acceleration but there's a continuing increase in compliance, a continuing increase in compliance.

Representative RICHMOND. At the beginning of your statement you said the degree of compliance in the United States is much higher than in Europe.

Mr. KURTZ. I didn't say it here, but I have said that, but let me say that I think the current IRS estimates of noncompliance are overstated. That does not mean that there is not still a very serious compliance problem.

Representative RICHMOND. What percent of compliance is there in this country?

Mr. KURTZ. Overall? You're probably talking—I think the IRS is estimating noncompliance at something like probably 20 percent of the tax base. My guess would be that it's perhaps more on the order of 12, 13, or 14 percent, but that's a lot and that's too much.

Representative RICHMOND. That's the individual tax base or the total?

Mr. KURTZ. Individual. Well, they estimate across the board, but it's about that on the individual.

Representative RICHMOND. One last question then. How would you simplify the business tax rates?

Mr. KURTZ. Well, on the business tax returns you have essentially the same problems you have on the individual tax, and that is, that the business taxes are riddled with scores of deductions and credits which have little to do with income. That is, if you compare a corporate tax return with a corporation's annual statement, you'll find deduction and credit one after the other on the tax return which don't appear on the corporation's financial statement, and the elimination of those are greatly simplified.

Let me add one other thing. The issue of simplification in the corporate area is a different issue than in the individual area. Computation of business income by its nature can't be completely simple. There is no simple way to determine the taxable income of a multinational corporation. It's a complicated business and a lot of the rules are essentially complicated. But those businesses are much better able to cope with a certain degree of inherent complication than the average taxpayer whose financial affairs are rather simple but who is so intimidated by the tax system that he feels unable to cope with it. That is not the case with major corporations.

Thank you.

[The prepared statement of Mr. Kurtz follows:]

Prepared Statement of Jerome Kurtz

Mr. Chairman and Members of the Committee:

My name is Jerome Kurtz. I am a lawyer in private practice in Washington, D.C. Today, I appear in my individual capacity in response to your invitation to participate in this important hearing concerning the so-called "simplified flat rate tax."

It is critically important in discussing this subject to draw a sharp distinction between the issue of simplification, on the one hand, and rate structure, on the other. The complications in our individual income tax system have very little to do with rate structure. Instead, they are almost wholly a result of the growth of tax expenditures within the income tax code.

The goal of an income tax law should be to define income as a measure of a person's ability to pay tax. Most of the complexity in our income tax system, however, is not related to defining income as a measure of tax paying capacity, but rather is attributable to provisions designed to encourage or reward taxpayers for making particular kinds of investments or expenditures. The income tax code has seen a proliferation of exclusions, deductions, credits and other tax benefits which are unnecessary, and in fact have proved detrimental to the proper function of an income tax. It is these provisions which account for most of the complications within our tax system.

Within the Internal Revenue Code, one can find two very different programs. There is, hidden away within its pages, a basic income tax system, that is, a set of rules to measure income for the purpose of determining a taxpayer's capacity to share the cost of government. However, there are also over a hundred provisions which administer, through tax relief, programs that more traditionally, and more properly, should be considered spending programs.

Our tax system has its problems. It is too complicated, it is unfair, rates are too high and compliance is falling. The answer to these problems lies in vastly simplifying the system -- returning the tax law to its original purpose of measuring one's ability to pay tax. This means eliminating or vastly reducing the number and size of tax expenditures. It does not mean substituting a flat rate for a progressive rate structure.

Using the tax system to further specific economic and social programs has seemed attractive because tax expenditures appeared easier to administer than direct spending programs and provided almost a complete absence of red tape. Moreover, they did not appear on the budget.

We have, I hope, come to realize that ease of administration and absence of red tape has only meant misdirected programs and waste. And I assume we all now realize that tax expenditures cost the same as comparable direct programs. This has become painfully apparent as we have seen our

tax base shrink at the same time as the pressure for greater tax expenditures has increased. A cycle has ensued wherein the erosion of the tax base due to the granting of special tax relief leads to higher marginal rates which in turn only increase the demand for special relief.

What was not well recognized as the number and size of tax expenditures grew was the cumulative effect they were having on the tax system.

We have a voluntary compliance system, and may be asking too much of taxpayers to assess and pay their own tax when they have little understanding of how the system works. The complexities of the system breed suspicion.

The presence of tax expenditures creates unfairness and resentment among taxpayers which cannot fail but to diminish compliance.

An individual with income from oil wells or real estate has the same tax-paying capacity as one with an equal amount of income from wages. And yet, in most cases, the wage earner will pay substantially more taxes because taxable income from oil is reduced by a depletion allowance unrelated to real depletion, and the landlord has excessive depreciation deductions. Neither of these deductions reduces the amount of real income in an economic sense.

Moreover, various exclusions, deductions, and credits result in cases where those with a greater tax-paying capacity pay substantially less than those with a smaller capacity.

Furthermore, taxpayers with the same tax-paying capacities can pay very different amounts of income tax. For example, homeowners and renters with the same incomes have the same tax-paying capacities. Yet because homeowners may deduct interest and taxes in computing the amount of income which will be subject to tax, and renters may not, the homeowners pay less income tax. Or compare two families with equal incomes, one of which has a more expensive home spending more for interest and taxes, and less for food than will the other who has chosen to live in a smaller house and go to restaurants more often. Their tax-paying capacities are the same but our tax system treats them differently.

Tax expenditures also create inefficiencies within our economy as a whole. Gross economic distortions are encouraged under our existing system because decisions--particularly investment decisions--are greatly influenced by the availability or lack of availability of various tax benefits.

Individual income tax collections this year will amount to some $300 billion. And, according to official estimates, tax expenditures for individuals will be about $200 billion. That is the amount of additional tax that would be collected if there were no tax expenditures in our law. The relevance of these figures is that if there were no tax expenditures, rates could be reduced by about 40 percent, and the same revenue targets would still be achieved. Eliminating tax expenditures would result not only in a far simpler tax law, but a

more equitable distribution of the tax burden, and significantly lower marginal rates as well. Incentives would increase, compliance would improve, and economic efficiency would be greatly enhanced. Investment decisions would come to be based on real value in the market place and not on rates of return artificially influenced by the tax code.

I might add that I do not believe it possible or fair to scrap our present tax system in favor of one with a comprehensive base overnight. Commitments have been made and markets have adjusted to some aspects of existing law so that, while many changes can be made immediately, others may have to be made gradually.

Simplification would produce a broader tax base and consequently lower rates. Whether the rates applied to such a base should be flat or progressive is a separate question. This is an important point, because the recent call for a "simplified flat rate tax" has seemed to imply that much of the complexity in our tax code results from progressivity. This is simply untrue. While a small degree of complexity is attributable to progressive rates, it is certainly not of the order or extent necessary to suggest a major shift in the distribution of our tax burden.

If a flat rate were applied, even to a greatly simplified and therefore expanded definition of income, the result would be substantial increases in the taxes of most lower- and middle-income taxpayers and corresponding reductions in the tax liabilities of those with the highest incomes. It is

sometimes claimed that a flat-rate tax would not reduce taxes for the rich because, with tax shelters and special benefits, they pay little taxes today. This assertion is untrue. While some wealthy people do pay little or no tax, many pay very substantial amounts. On average, our income tax system remains progressive, although it has become less progressive since the enactment of last year's Economic Recovery Tax Act. Nevertheless, all proposals for flat rate taxes would cause large tax reductions for the highest income taxpayers at the expense of the less affluent.

The following figures are cited from testimony presented by Mr. Joseph J. Minarik of the Congressional Budget Office before this committee on July 27, 1982. They are comparisons with tax rates for 1984, when the tax deductions legislated last year will be fully in effect. If all itemized deductions were eliminated and long-term capital gains were taxed in full --using present law exemptions and standard deductions--a flat rate of 15.7 percent would raise the same amount of revenue as the present system. But it would raise it quite differently. Those with incomes of between $5,000 and $10,000 would have average tax increases of 36 percent; $10,000 to $15,000, 25.5 percent; and $20,000 to $30,000 would have 13.4 percent increases. On the other hand, those with $100,000 to $200,000 in income would have a 33.2 percent average reduction in taxes, almost $10,000 per return. Those with more than $200,000 in income would save an average of $38,000 each, a reduction of 38.7 percent.

The outcome would be somewhat improved if the personal exemption were increased from $1,000 to $1,500 and the standard deduction for a married couple were raised from $3,400 to $6,000. The first $12,000 of income for a family of four would then be exempt. The rate needed on all other income to raise the same amount of revenue as the 1984 rates would be 18.7 percent. Under this scheme, those at the very bottom would, of course, fare better. But the middle-income taxpayers would still have significant increases, and the top earners large reductions. Those with $15,000 to $20,000 in income would have a 7.7 percent increase; those with $20,000 to $30,000 income, 9.3 percent; while those with $50,000 to $100,000 would have a 6.7 percent reduction. The decline for those with more than $200,000 in income would average about $28,000 per return, 27.7 percent of total liabilities.

The debate about the fairness of progressive rates compared with a flat rate generally focuses on the individual income tax alone. However, the income tax is only part of the total tax burden, and should therefore be considered in perspective.

Aside from the individual income tax, most taxes are not only not progressive, they are not even proportionate. The individual income tax will raise about $305 billion this year. Social security taxes, the second-largest source of federal revenue, will raise about $225 billion, and will raise that enormous sum in a clearly regressive manner. Under present

law, wages are subject to social security taxes of 6.7 percent on both the employer and the employee, with income from self-employment subject to a rate of 9.35 percent. The tax applies from the first dollar of income without exemptions or deductions, but it does not apply to wages or self-employment income over $32,400. It does not apply to interest or dividends, nor to any income other than that from wages and self-employment.

Thus, taking social security taxes into account, the total federal tax burden is roughly proportional today--not progressive. In fact, it is progressive income tax rates which keep the system from becoming regressive as a whole. The question, therefore, should not be whether to have a flat rate or progressive income tax, but whether the income tax should be sufficiently progressive to make the total federal burden progressive.

While economists and social philosophers may debate whether a progressive tax system is fair, the fact is that most people think it is. It seems reasonable that the cost of government be borne in a manner having a relation to the rewards one receives from the system and that the most affluent pay proportionately more than those less fortunate. While we are committed to free enterprise--a system relying heavily on economic rewards to provide incentives--it is widely recognized that this system requires constraints if it is to work effectively and fairly. We have child labor laws and antitrust laws

to moderate the caprices of uncontrolled free enterprise. While most believe deeply in rewards and incentives, most also believe there must be limits.

Some complexities do result from a progressive tax system. With progressive rates, it makes a difference in what year income is earned. Therefore, we have built income averaging into the system today to resolve that problem. The extent to which one needs income averaging with progressive rates, of course, depends upon how broad the income brackets are and the degree of the progressivity itself. Progressive tax rates also require that we deal carefully with problems of the taxpaying unit.

However, with a broad base, lower rates and wide brackets, the degree of complexity attributable to progressivity is not serious. The main problems which complicate the income tax code stem directly from the tax expenditure system, and can be solved without regard to rate structure. We should not, and need not, abandon equity to the cause of simplicity. Those who advocate a flat rate do so for reasons unrelated to simplification. The issues should not be confused.

Representative RICHMOND. Representative Hansen.

Representative HANSEN. Thank you, Congressman Richmond. I do have a couple of questions. I appreciate the opportunity to sit in for a few minutes.

Representative RICHMOND. Congressman Hansen, it's always a pleasure to see you.

Representative HANSEN. It's a little ways from food stamps, isn't it, Congressman Richmond?

The problem of the budget and the tax bill before us in the House of Representatives today and which will be before the Senate shortly if it passes the House I think brings to mind one thing and I'd like to ask you, Mr. Roberts, if you feel that the real flat, flat rate tax that you advocate without the structure that some advocate, if that would be a revenue generator that would not impose more burden upon the group of people who are now paying taxes but would still provide a significant amount of revenue for the Federal Government to get us through this problem of deficits and high debt? Is there potential of that in the flat rate tax?

Mr. ROBERTS. Yes, sir. Yes, there is, Congressman Hansen, definitely.

Representative HANSEN. Would you spell it out briefly?

Mr. ROBERTS. Well, the flat rate tax not only greatly expands the tax base by closing the deductions and exemptions, but it also expands it greatly in other ways as well. One is from the effect on economic activity of the terrific incentives of a very low marginal rate of tax and that is the rate of tax on any additions to income earned. That effect works to expand the base.

Also, the base is expanded by the effect of a very low rate of tax on income, that effect on the activity of the underground economy, those activities that Mr. Kurtz was estimating at 12 or 14 percent and the IRS at 20 percent. The rate of flow into those activities declines, then that helps the tax base, and if the absolute size of those activities declines, as it would if you gave it amnesty to bring people back to the tax base, then you also benefit from that effect on the tax base.

You benefit as well from the economic efficiency effects of taxing all income at the same rates. The current tax system has very substantial distortions in investment decisions, in rates of returns, from the fact that the current tax system taxes income at differential rates—different sources of income.

All of those effects would work to make the tax base much larger than simply the addition back of the so-called tax expenditures. In addition, you would have the effect of the low marginal rate of tax and the lower average rate with the flat rate of reallocating capital away from tax shelters back to productive activities which would affect the rate of growth of the economy and therefore the tax base. So the net gains to the tax base from a flat rate system would be larger than the sum of the tax expenditures that would be added back.

Therefore, it is not simply—in other words, there is a net gain to the economy of moving to a rational form of taxation and so, with all of those factors considered, you would have to conclude that the actual rate of tax that it would take to replace existing revenues would be lower than the roughly 13 percent estimate that is now computed based on just the static considerations.

Representative HANSEN. At a 13-, 14-, or 15-percent basis, very briefly, what would you expect from task force studies in the Treasury Department or anything else you might be familiar with would be the increased revenue over the revenue that's now generated by the existing progressive system?

Mr. ROBERTS. It's very difficult to estimate the effect on the tax base, like the first year out, the second year out, of the incentive effects and the limination of distortions and investment decisions of moving to a flat rate, but I would be willing to guess that probably a 13-percent flat rate would not just replace existing revenues but it would probably go a long way toward balancing the existing budget.

Representative HANSEN. Mr. Kurtz was talking about 20 percent non-compliance.

Mr. KURTZ. I don't have those figures. I believe that's what the IRS is now estimating roughly.

Mr. ROBERTS. But the IRS tends to overestimate because they always use them as an argument for more IRS agents and so informed budget fights——

Representative HANSEN. Do you demand equal time, Mr. Kurtz?

Mr. KURTZ. Well, let me say we did the first comprehensive estimates in 1979 and were broadly criticized for underestimating, and there was no one who claimed it was an overestimate, but the IRS today has upped those estimates very substantially.

Mr. ROBERTS. But you have claimed that it's an overestimate.

Representative HANSEN. The point I'm making, do you feel, Mr. Roberts, that there is sufficient incentive in the low flat tax to bring people perhaps back into the system maybe better than sending out more compliance officers to audit them?

Mr. ROBERTS. Yes, definitely. It's supposed to be a voluntary system, so compliance officers are already assigned a breakdown and more compliance officers are assigned an even further breakdown. So that is the direction we're going. You may know that the estimates of the revenues to be raised from this tax bill are in part from more compliance and more compliance agents. I think the figure is 5,000 more IRS agents.

Mr. KURTZ. There's no estimate for that in the tax bill.

Mr. ROBERTS. The estimate of the revenues or the compliance officers?

Mr. KURTZ. There's no estimate for any revenue from increased agents. It's from new penalty provisions from withholding. It is a recommendation for more agents but no estimate is associated to that.

Representative HANSEN. I might just mention there's a real feeling in the House of Representatives about the problems of sending a lot more compliance agents out and there has to be a better way to do it perhaps in the voluntary system by inducement. In fact, I've chided a few people that if there are 5,000 new agents sent out, as has been suggested, divided by 435 Congressmen, that gives you 12 agents per congressional district that you're taking home and I tell people in a biblical sense is what you're doing is taking 12 IRS apostles out to put hands on the people with a new set of stone tablets. Thank you, Congressman Richmond.

Representative RICHMOND. Thank you, Mr. Hansen.

Mr. Christian, I'm sorry to take so long but we look forward to your testimony. Go ahead.

STATEMENT OF ERNEST S. CHRISTIAN, JR., FORMER DEPUTY ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY

Mr. CHRISTIAN. Thank you, Congressman Richmond.

For somewhat different reasons, I would agree with Jerry Kurtz that the term "flat rate" tax implies too much. We should, in my view, instead, be talking in general terms about a tax that would apply a set of lower than present progressive rates to an expanded income base. The goal of that tax should also be to apply the income tax to a broader base of taxpayers. With low progressive rates of tax ranging from say 2 to 35 percent, it would be possible to include as a taxpayer everyone who has significant income. Everyone would pay a little bit of tax and be part of the system but no one would pay too much tax.

On the other hand, if we had a flat rate tax with a single rate of say 18 percent, it would probably be necessary to have a total exemption from tax for people with income up to $15,000 or $20,000. That would result in a very large number of people being totally outside the tax system.

Even under our present tax system, we are, I believe, approaching the point where perhaps more than a majority of voters who either do not participate in the tax system at all or do not significantly participate.

I would suggest that it is very bad policy for one group of citizens to vote to tax another group without themselves bearing any part of that burden. I would point out as an aside that the Minarik figures that Mr. Kurtz cited to the effect that even with our present tax base a flat rate of 18 percent would produce the same amount of income. That certainly implies that there are an awful lot of taxpayers who are paying rates a lot less than 18 percent.

I also think that the so-called flat rate tax debate should include a discussion about a somewhat similar revision of the corporate tax system as well as the individual tax system.

Certainly the idea of a broad-based low tax is not new. It's been around for a long time. The question, then, is: Why is there so much current interest in that subject? It's certainly true, as Jerome Kurtz has said, that such a tax system would be simpler than our present really ridiculous complex tax system and no doubt I think today the broad-based low rate tax impetus in part arises from a generalized sort of yearning to a return to a simpler and more predictable world that's not so much complicated by a maze of bureaucratic regulations and so on. However, we've lived with such complexity for a long time and the need for tax simplification has been broadly and well argued for a long time.

Closely related to the idea of tax simplification I think is the current political mood for deregulation. I believe that the present corporate and individual tax systems are a form of regulation. They are the product of almost two decades of really constant interference by the Congress to the tax system using high nominal rates as very powerful instruments of regulating social and commercial conduct. Now that instrument derives its power solely from the fact that our nominal rates of tax are very high in combination with a whole series of special deductions and credits and exclusions for engaging or refraining from engaging in certain activities.

Now those exceptions are certainly just about guaranteed to influence personal and commercial behavior as long as nominal tax rates are high, but they certainly would not influence behavior very much if rates were low, which is really what you're talking about when you talk about a flat rate tax. The rates can either be flat or they can be low progressive rates, but they are in all cases low. Such a tax system would not function as any type of significant regulatory device.

I think that similar to the concept of tax deregulation is the fundamental argument about economic efficiency and resource allocation. It seems to me that, by and large, both so-called liberals and conservatives today would generally subscribe to the idea that high nominal rates of tax serve as significant economic disincentives. The debate surrounding the major tax cut in 1981 was dominated by expressions of concern about high marginal rates of tax. In this sense, at least as applied to individuals, a broad-based low rate tax or a flat rate tax can be viewed merely as the further and ultimate extension of the process of lowering marginal rates that began in 1981.

Also, today, when there is probably somewhat less faith in the infallibility of Government, and an obvious concern that something is wrong with the economy, it is both natural and appropriate that many people would raise questions about the efficiency of the enormous resource allocations and misallocations that are brought about by our current tax laws. Both our corporate and individual tax systems are characterized by random unevenness of the tax burden, with some firms and some individuals paying tax at very high effective rates and accounting for most of the taxes that are collected, while others with equal or greater financial incomes pay little or no tax. Out of that current complex, criss-crossing, overlapping system of special deductions and credits and exclusions that we have in our present law, there are clearly many winners and many losers. There are large numbers of competitive advantages and disadvantages in the marketplace and otherwise that arise solely from our present complex system. Those create advantages for one firm over another, one region over another, one category of individuals over another, and on from that.

Many tax provisions, so-called tax preferences, that we have in our law today are so powerful and so ingrained in the system that whole ways of doing business and whole careers are built around them and shaped around them. I think in recent weeks in the present tax increase bill——

Representative RICHMOND. Mr. Christian, they're called tax shelters.

Mr. CHRISTIAN. Well, probably a little bit more than tax shelters. I think there's more than a traditional view of a tax shelter involved, but the controversy about the tax increase bill that is on the floor of the House today I think has illustrated how very difficult it is to change in any material way this set of special deductions and credits and exclusions with which our system is presently replete and we may find that there are some significant economic costs associated with trying to withdraw from that system of tax regulation, particularly as in the current tax bill when we attempt to do that selectively and on a piecemeal basis without at the same time addressing ourselves to the problem of reducing rates. And there are clearly, again, winners and losers in the current tax bill and that win or that loss is made a great deal more significant by the fact that we have nominal tax rates. If the tax rates were lower, people wouldn't care so much.

I think while all of these points are factors which have motivated a growing interest in a flat rate tax or a broad-based low rate tax, I believe a major source of interest clearly arises out of a current fundamental debate about the Federal expenditures policies and about the argument over big government versus small government.

One could speculate at least that the current tax system as it's presently structured is probably not a sufficient revenue device to assure a sufficient flow of revenues for the remainder of the decade. It's a little bit of a dilemma. Too high nominal tax rates cannot be increased to raise more revenue, but the income base is so eroded that even those high tax rates do not produce enough revenue.

On the other hand, restoring that income base on a piecemeal basis, in the face of high nominal rates, is a difficult and risky proposition.

The broad-based low rate or the flat rate tax has a certain amount of current appeal. Someone who believes in small Government might consider that the only way to bring down Government expenditures is to constrict the flow of Federal-tax revenues. Someone of that persuasion might consider a broad-based low rate tax, with emphasis on "low rate," as just the way of doing that. After all, most versions of a broad-based low rate tax would be pretty hardpressed to raise as much money as the present system, at least that's my own view, in terms of the practical political outlook.

There are others in this same debate over size of Government and Federal expenditures policy who also are interested in a broad-based low rate tax or a flat rate tax and from their standpoint they perhaps, and legitimately so, might view it as a way of assuring a growing level of Federal revenues once the base were broadened and then the only question is, what are the rates?

The point there, it seems to me, to be simply that the term flat rate tax means many things to many people and ultimately it depends solely on the relationship of what the base ends up to be to the rates.

In my own mind, the term "flat rate tax" merely stands for the basic idea that our present tax system, both individual and corporate, is greatly in need of major revision. It may not be possible to achieve that major revision except by setting aside the present system and starting all over again. The result of that would probably be a tax system with a much broader base and much lower rates than at present and that tax could either raise less, the same, or greater revenues than the present system.

Thank you very much.

[The prepared statement of Mr. Christian follows:]

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Prepared Statement of Ernest S. Christian, Jr.

The term "flat rate" tax implies too much. We should, instead, be talking in general terms about a tax which would apply a set of lower-than-present progressive rates to an expanded base of income. The goal of such a tax should not only be to apply the income tax to a broader base of income, but also to apply the tax to a broader base of taxpayers. With low progressive rates of tax ranging from, say, 2% to 35%, it would be possible to include as a taxpayer everyone who has significant income -- everyone would pay a little tax, and be part of the system, but no one would pay too much tax.

If we had a flat rate tax, with a single rate of, say, 18%, it would probably be necessary to have a total exemption for taxpayers with income up to $15,000 to $20,000. That would result in a very large number of people being totally outside the tax system. Even under our present tax system, we are approaching the point where perhaps a majority of the voters are, for one reason or another, outside the tax system. I would suggest that it is bad policy for one group of citizens to vote to tax another group without themselves bearing any part of that burden.

I also think that the so-called "flat rate" tax debate should include a revision of corporate taxes as well as individual taxes.

The idea of a broad-based low rate tax is not new -- it has been around for a long time. Why, then, is there so much current interest in the subject? Certainly, such a tax system would be much simpler than our present ridiculously complex tax system for both individuals and corporations. No doubt, the impetus for a broad-based low rate tax in part arises from a generalized yearning for a return to a simpler, more predictable world -- not complicated by a maze of bureaucratic rules and regulations of which our current tax system is a prime example. However, we have lived with such complexity for a long time and the need for tax simplification has been argued broadly and well for a long time.

Closely related to simplification is the current political mood for deregulation. The present corporate and individual tax systems are the product of two decades of almost constant legislative interference during which time the tax system has been used as a powerful instrument of social and economic manipulation. This instrument derives its power from the continued maintenance of high nominal rates of tax in combination with special deductions,

exclusions and credits that provide exceptions for engaging in or refraining from certain specified activities. Such exceptions are almost guaranteed to influence behavior when tax rates are high, but not when tax rates are low. A broad-based low rate tax would be solely a means of raising revenues to fund government expenditures. Such a tax would not serve as an effective regulatory device.

Similarly, and closely related to "tax-regulation" is the fundamental argument about econmic efficiency and resource allocation. Both liberals and conservatives today generally subscribe to the idea that high nominal rates of tax -- which we today impose on both individuals and corporations -- serve as significant economic disincentives. The debate surrounding the major tax cut in 1981 was dominated by expressions of concern about high marginal rates of tax. In this sense, at least as applied to individuals, a broad-based low rate tax can be viewed merely as the further and ultimate extension of the process of lowering marginal rates that began in 1981.

Also, today, when there probably is less faith in the infallibility of government, and an obvious concern that something is wrong with the economy, it is both natural and appropriate that many would raise questions about the efficiency of the enormous allocations and

misallocations of resources that are brought about by our current tax laws. Both our corporate and individual tax systems are characterized by random unevenness of the tax burden -- with some firms and individuals paying tax at very high effective rates and accounting for most of the taxes that are collected, while others with equal or greater financial incomes pay little or no tax. Out of our current complex, criss crossing, overlapping special deductions, credits and exclusions, there emerge many winners and many losers. Access to resources and competitive advantages and disadvantages -- one individual over another, one firm over another, one category of persons over another, and one geographic region over another -- all flow accordingly.

Many tax provisions are so powerful and so ingrained in the system that whole ways of doing business and whole careers, are built around them and shaped by them. In recent weeks in the controversy over the current tax increase bill, we have seen how difficult it is to change some of these provisions. We may also find out that there are great economic costs associated with trying to withdraw from "tax-regulation," particularly when, as in the current tax bill, we attempt to do that selectively and piecemeal without reducing overall tax rates. There clearly were winners and losers in the current tax bill

as there are each time we have a major tax revision -- which we now seem to undertake every year or so.

While the foregoing factors, no doubt, contribute to the new interest in the broad-based low rate tax, I believe the impetus primarily arises out of the current fundamental debate over tax/expenditure policies, and out of the big government vs. small government argument. One thing ought to be clear -- the current tax system is probably not a sufficient revenue device to assure a sufficient flow of tax revenues for the remainder of the decade. Already too high nominal rates of tax cannot be increased to raise more revenue, but the income base is so eroded that even those high rates of tax do not produce enough revenue. On the other hand, restoring that income base on a piecemeal basis, in the face of high nominal rates, is a difficult and risky proposition.

Now consider the broad-based low rate tax. Someone who believes in smaller government, might consider that the only way to bring down government expenditures is to constrict the flow of federal tax revenue. Someone of that persuasion might consider a broad-based low rate tax, with emphasis on "low rate," as just the way of doing that. After all, many versions of a broad-based low rate tax would be hard put to raise even as much revenue as

the present system. Certainly, a tax system with low rates would, at least for a time, produce less revenue than will be derived if the present high rates are maintained and we go through a series of tax bills like this year's where many or most so-called tax preferences of present law are eliminated.

On the other hand, a broad-based low rate tax is supported by many who would desire to have a large revenue base to support a high level of federal expenditure programs. From that point of view, over the long haul, a greatly broadened tax base holds out the prospect of significantly greater revenue even if tax rates initially are low. Moreover, it may be thought that most of the "tax preferences" that would be eliminated would primarily affect higher income individuals and businesses, not low or middle income people.

The point is simply that "flat rate tax" means different things to different people. In my mind "flat rate tax" simply stands for the basic idea that our present tax system -- both for individuals and corporations -- is greatly in need of major revision. It may not be possible to achieve that except by setting aside the present system and starting all over again -- the result of which would probably be a tax system with a broader base and lower rates which could raise less, the same or greater revenue than the present tax system.

Senator JEPSEN [presiding]. Thank you, Mr. Christian.

Representative RICHMOND. I think, Mr. Chairman, during your absence it became very obvious that Mr. Christian and Mr. Kurtz believe in simplifying the present tax code and I believe Mr. Roberts and Mr. Bradford believe that a flat rate tax would be effective. Am I right, gentlemen, when I say that? Am I right when I say that Mr. Bradford and Mr. Roberts believe that a flat tax rate is plausible and Mr. Kurtz and Mr. Christian believe we ought to take our present tax system and vastly simplify it and close our loopholes? Is that the bottom line?

Mr. BRADFORD. I would put myself in the middle of that. I think we could do a great deal by improving our present tax system and I'm not an advocate of a flat rate.

Representative RICHMOND. Mr. Roberts is.

Mr. ROBERTS. Yes. I'm willing to trade the tax expenditures for a low tax rate and I think Mr. Kurtz wants to simply take away the tax expenditures and leave the high progressive system.

Mr. KURTZ. No, I think that's a mistake.

Senator JEPSEN. We can't even agree on what the other says. Mr. Roberts, are you flat out for a flat tax?

Mr. ROBERTS. Flat out for a flat tax.

Senator JEPSEN. Mr. Kurtz.

Mr. KURTZ. I would try and summarize it in one sentence. I would favor vastly simplifying the code by eliminating most credits, deductions, special exemptions, and so forth, which would permit vastly lower rates at all levels, but I would maintain progressive rates albeit much lower than they are today.

Senator JEPSEN. Well, from your testimony and having been briefed a little beforehand, it seems to me that you seem worried that a flat tax rate would lead to an undesirable redistribution of income. Is that accurate?

Mr. KURTZ. That a flat rate would result in a substantial redistribution of present tax burdens downward.

Senator JEPSEN. And you're worried about that?

Mr. KURTZ. Yes.

Senator JEPSEN. Mr. Christian, what's your reaction to that concern?

Mr. CHRISTIAN. Well, I do not believe, Mr. Chairman, that the fundamental debate is over a flat tax rate or a broad-based low rate tax with progressive rates. The issue is lower rates of tax applied to a broader base of income and to a broader base of taxpayers. Now Jerry's point that there would be redistribution if there's a flat rate tax is true, but there would also be redistribution if instead of having a flat rate tax you simply lower the schedule of progressive rates substantially compared to what they are now. There would also be a redistribution then.

Senator JEPSEN. Well, do you agree with his statement? Do you agree that tax simplification is possible without going to a flat rate?

Mr. CHRISTIAN. I believe myself, Mr. Chairman, that the flat rate is irrelevant. The issue is low rates. I believe that it is not possible to achieve simplification without going to much lower rates of tax than we have now. I do not believe the issue is fundamentally flat versus progressive. It's lower.

Senator JEPSEN. What do you think then about the argument that if we allow progressive rate structure to exist with the broad base future Congresses could raise the top marginal rates making the system far more progressive than at present and at the same time destroying incentives to save or work?

Mr. CHRISTIAN. That is always a possibility, Mr. Chairman. It is equally a possibility with any type of a flat rate tax which realistically might be expected to come out of the Congress because the flat rate taxes generally have very large exemptions so that they would say that everybody pays a flat rate of tax of 18 or 20 percent but if your income is below $15,000 or $20,000 you don't pay any tax; you're totally outside the tax system.

The point I made in that regard when you were out of the room, Mr. Chairman, was that is one of my principal objections to that form of flat rate tax because you end up with a very large number of the citizenry and voters who are outside the tax system altogether but who vote to impose taxes on the rest of the folks.

Senator JEPSEN. Are you saying those in Congress do not pay their fair share of taxes or did I misunderstand you?

Mr. CHRISTIAN. No, sir. I meant that the citizens who would be electing Members to Congress or supporting or opposing the various tax increases—you would have a very large number of them who paid no taxes whatsoever and might be in favor and tell their Congressman and so forth to simply raise the exemption level and in that case you would get the same result as raising the top marginal rate.

Senator JEPSEN. I see. You're saying that everybody ought to pay some tax?

Mr. CHRISTIAN. Yes, sir.

Senator JEPSEN. Mr. Roberts, do you have a comment on this?

Mr. ROBERTS. Yes, several. I think we already have a situation where there are many people who vote who don't pay taxes and they file and collect what's called the earned income credit. So you have quiet a large number of people who are already playing the game Mr. Christian just spoke of.

I think the advantage of a flat rate system is that there is a de facto way to do some progressivity from the income exclusion, so it doesn't have to be so large as to exclude people with $20,000 of income. The advantage of it is that de jure there's one flat rate and therefore one tax rate and therefore you have a hard time separating one group of taxpayers out from another because there's one tax rate. If you're going to raise taxes, you have to raise everybody's taxes who pays them. But if you have a progresive system you can do exactly what you said. The taxpayers can be split off and turned against each other and you can always raise the rates where there are minority votes.

So the advantage of a flat rate system is that it is a single rate de jure and therefore it makes it difficult to split the taxpayers into camps.

I think, in addition, that what I've heard today there's a great deal of concern about distributional matters with total neglect to the expenditure side of the budget, and I would imagine that the expenditure side of the budget contains most of the redistribution. The redistribution is not achieved through the collection of revenues. In fact, you could have a progressive collection of revenues which was highly regressive in the distribution of benefits.

The issue of distribution is irrelevant to the collection of tax revenues. It is something that is handled through the expenditure side of the budget and a tax system should focus on maximizing the rate of growth in the economy. You cannot simply think you're dealing with so-called questions of equity by looking at the tax side and neglecting whether or not the tax system is prohibiting economic growth and investment which gives opportunities to people.

You could define a tax system according to the terms we heard today, terms which I reject because they're discriminatory and they discriminate against people according to the size of their income—it's the last legal form of discrimination in our laws. We've eliminated all other forms of personal discrimination—race, sex and age—but we still legally discriminate against people according to the size of their income.

I think that what has to be taken into account and has not been in this discussion is what is the effect of the tax system on the economy and on the growth of the economy and on the deficit and on the growth of opportunities for people, and that broader consideration has to be what defines equity.

Senator JEPSEN. Well, I assume, Mr. Roberts—and then we'll get to you, Mr. Kurtz—that you really believe that a very simple flat rate tax, perhaps something similar to the Hall-Rabushka bill, is the real supply-sider's dream?

Mr. ROBERTS. It would maximize opportunities for people and that is what a society should do.

Senator JEPSEN. Mr. Kurtz.

Mr. KURTZ. Well, I guess I would respond to a couple of remarks that were just made.

As far as discrimination is concerned, I don't quite understand the argument because I don't understand Paul Roberts to be saying that there should be no exemptions in the tax system, so any system, whether it's a flat rate or progressive rate, we're going to exempt low-income people and therefore there is discrimination built into it in some sense. It's only a question of how much. I don't understand how it would be a discrimination argument how the tax burden is distributed any more than it's a discrimination argument to say that we pay unemployment to people who are unemployed. I guess one could argue we're discriminating against the employed when we pay welfare people who don't have any income and therefore we're discriminating between high and low income.

The tax system is designed to raise revenue and I don't think Paul Roberts would argue that we want to raise the same revenue from each person. I mean, one could argue that the ultimate nondiscrimination is to have a head tax and just collect $1,000 from each person in the United States whether they can afford it or not. So it's a question of degree really whether we have flat rates or marginal rates. It's not a moral issue. It's an issue of, I think, primarily what people view as fair and what the future of the tax system will be. If the tax system operates in a way which permits very large accumulations of wealth which I think a flat-rate system inevitably would, that resentment will have to grow among the middle class and I think the tax system will not function as well in the long run.

As to spending programs, it may be that—well, it is true certainly that there's a substantial redistribution of spending programs. I didn't understand that the call for the flat rate would change the spending programs. One obviously could set a flat rate at a fairly high level, say 30 percent or so, and then redistribute back to the low and middle classes to come out with a system that overall was more progressive than the one with narrower spending programs and progressive rates. But as I understood the testimony, you're assuming that spending programs remain relatively constant and we're talking just about the tax side of it and therefore you would have a siginficant change in tax burden from high- to middle-income people.

Mr. ROBERTS. I don't agree with that. Mr. Kurtz assumes that the activities that are being taxed will remain the same regardless of the form of the taxation and you can't know where the distribution of the tax burden will be unless you know where the distribution of the activities is. If people respond to incentives and produce a lot more income, then you can't say that the tax burden has shifted downward. In fact, I think the IRS's own statistics of income I believe show that the rather substantial reductions in the tax rate in the 1920's under Secretary Mellon resulted in the upper income brackets paying a larger proportion of the tax revenues paid; that is, the amount of tax they paid rose even though the rate of tax that they were taxed at declined.

Senator JEPSEN. Mr. Kurtz, aren't you suggesting that the original purpose of the tax law is to measure the ability to pay?

Mr. KURTZ. Yes, that was the gist of my statement.

Senator JEPSEN. So then you go on to how do you define—and that's what you're getting at I think—ability to pay. Can you do it scientifically or objectively?

Mr. ROBERTS. I don't think ability to pay is a rational or equitable approach to designing a tax system. In fact, what Mr. Kurtz's argument comes to it seems to me, is that he seems to believe that we need a progressive system in order to appease—that the function of a progressive system is to prevent the accumulation of wealth. Well, that almost says that the function of a progressive system is to prevent a successful economy.

Mr. KURTZ. Well, that's not what I'm saying at all. One can phrase it that way but that doesn't address the issue. I think we have all recognized that—perhaps we can agree on this—that a free market economy completely left alone would produce great inequities. We have child labor laws, for example. We have antitrust laws, for example, because, whether they're perfect laws or not, I think we generally recognize that we need some constraints on the free market economy to keep it relatively fair.

I understand that people can disagree with notions of fairness. That is in one sense a personal issue as to how one sees the shape of society. Whether we have a flat rate or whether we have a progressive rate or whether we exempt completely very high income people may change in some sense the size of the pie, and I understand that. The next question, though, is then, how we distribute that pie and whether we consider it fair if the pie is slightly larger but the slices are of more different sizes than they are today.

Senator JEPSEN. Mr. Christian, do you have something to add?

Mr. CHRISTIAN. Well, I would say, Mr. Chairman, that I don't believe that we should get off into this debate about high-income people, low-income people distribution, what one particular view of society ought to be. I don't think that's the issue when we're talking about the flat rate tax which is—as I said, I don't agree with that terminology. I think the issue is just very simply one of whether we ought to undertake to revise the income tax system, both corporate and individual, to greatly broaden its base, to take some very hard looks at some of the tax regulation, in my view, that we've injected into the code over the last decade, and to try to get back to some realistic measure of income with lower rates.

I would be surprised if there were much argument if the proposition is put that way, if the proposal were to broaden the base of tax and to very substantially lower rates, I don't know that there ought to be much argument about that.

Senator JEPSEN. Well, in a minute, Mr. Bradford. I'm trying to find one common thread here that at least I detect that three of you have. That's Mr. Roberts, Mr. Kurtz, and Mr. Christian. Would you all agree that generally we need to broaden the base of the tax generally?

Mr. BRADFORD. I agree only if you lower the rates.

Mr. KURTZ. Oh, yes.

Senator JEPSEN. Only what?

Mr. ROBERTS. Only if you lower the rates. You see, much of the tax expenditures or loopholes are basically lifelines put there to prevent activities from being smothered by the blanket of high taxation.

Senator JEPSEN. But that is a thread—it would be inextricably involved or woven in the fabric of what you're proposed by way of a reorganization and by a new approach tax structure, that there would be a broadened base.

Mr. ROBERTS. But I emphasize not just the broadened base closing the loopholes but from the incentive effects.

Senator JEPSEN. I understand. But without fear of adding to whatever else, this is one thing that is in common. I'm not sure Mr. Bradford advocates that. Is the consumption tax broadening the base? How does that differ from the other three?

Mr. BRADFORD. Well, I think it's not necessarily very different since the other three haven't given the details of how they would broaden the base. Going to the cash flow tax such as described in my testimony would be one version of a vastly broadened base. So it's a matter of the details of how you do it.

Mr. ROBERTS. I think I would be correct in saying that Mr. Bradford's view of the broadened base is one that excludes savings.

Mr. BRADFORD. My preferred base certainly would.

Mr. ROBERTS. And that, of course, would be my preferred base as well. You exclude savings from taxation.

Senator JEPSEN. Well, Mr. Christian, what do you think of the idea of excluding all forms of savings from the tax base and taxing only when it's consumed?

Mr. CHRISTIAN. I find that a very intriguing idea, Mr. Chairman. We have been speaking in very general terms. I find that there's much attraction in the area of a cash flow tax. I find much attraction in the concept of not taxing savings. These are all issues that would inevitably have to be dealt with and decided under the broad umbrella of are we

going to go to some sort of a much broader base of taxation and have lower rates. I think these issues will inevitably come up.

Senator JEPSEN. Is that something all four of you agree on, that we should exclude savings?

Mr. KURTZ. No, I strongly dissent.

Senator JEPSEN. Oh, I thought we had something in common.

Mr. KURTZ. I do think we have common agreement on simplification, base-broadening, and lower rates. I think we diverge sharply after that as to the base and as to whether there would be a deduction for savings.

Let me say, when we talk about a consumption tax, I am assuming we're saying two things; and that is, No. 1, a deduction for savings and, No. 2, a tax on borrowing or consumption capital. I mean both sides of it if you're going to a cash flow tax. If you have a cash flow tax you're taxing consumption regardless of whether that consumption is out of current income or out of past savings or inheritances or life insurance or anything else. I'm assuming we have agreements on that. Otherwise, we've got the welfare income or consumption in the base only which is where we're headed today.

Mr. BRADFORD. If you're looking at me, I urge you to read my testimony.

Senator JEPSEN. Let me ask a simple mechanical question. On this savings, do you mean that all moneys that an individual would be putting into savings avoid taxes and all interest generated by this savings also avoids taxes so that everything to do with savings is not taxed? Is that generally it?

Mr. ROBERTS. That's basically my view.

Mr. BRADFORD. Unless it's taken out and spent.

Senator JEPSEN. Theoretically, when a person saves, economically a person's life value is exchanged for dollars, this is what this is all about. I mean you come into this life getting and you go out of this life getting and until you can give something, our economic value in exchange for dollars is worth very little.

We should put away something for a rainy day. When our human life values reaches its apex and starts downward in the sunset years of our lives, at that time it is taxed as today with double exemptions, for example, and so on. So that's what you're essentially saying. So anything that can contribute to the individual in the bigger picture that will enable, among other things, this individual in our society not to become dependent on the State, is a very valuable national goal and objective and, then, for the welfare and the dignity and the good well-being of those in the sunset years of their lives; that's why we want savings; is that right?

Mr. ROBERTS. That's right.

Senator JEPSEN. In the meantime, that savings that they put in our private sector of society make money available to use to invest and help build and perpetuate it. Is that a common thread?

Mr. ROBERTS. Yes, sir, Mr. Chairman.

Senator JEPSEN. Now, why, Mr. Kurtz, do you say that you don't agree with that?

Mr. KURTZ. No, I don't, Mr. Chairman. The basic reason is the same reason I don't agree with the flat rate applied to an income base and that is, that again it would significantly shift the tax burden from

the more wealthy to the less well-off inevitably, and that is because savings are a higher component of the income of the wealthy than they are of the middle or lower income groups and, therefore, particularly if you apply a flat rate to consumption, you will have a tax which is steeply regressive as to income.

I believe that income is a fairer measure of taxing ability than consumption and, therefore, I would like to see a tax that is related to income rather than consumption.

Now the answer to that may be that one could match a distribution of a model progressive income tax with a consumption tax if the rates were more steeply progressive on consumption because of the larger saving component for higher incomes, but I don't know that that's being advocated here.

Senator JEPSEN. Live today because tomorrow might be too late; is that what you mean?

Mr. KURTZ. No, because the assumption I think in what you are saying is that everybody consumes their income at some time in their life. I don't think that's at all true. The very high income and wealthy people are net savers or may be net savers throughout their life. Therefore, they would pay that tax. Now one way around that is to make a tax system come out roughly where it would be today is to say let's have a consumption tax but a very high estate inheritance tax so it would permit people to pay taxes as they consume throughout their life but then at the end of their life we pick up a significant portion of any of those savings to get back to where we would have been on a progressive income tax. Again, I'm not sure that's being advocated.

Senator JEPSEN. Mr. Bradford.

Mr. BRADFORD. I just wanted to offer a couple of comments. As far as the progressivity of a consumption-type tax is concerned, in the testimony that I've handed in and derived directly from the blueprint study, there's a set of estimates of the rate schedule which would have reproduced the distribution of burdens roughly in 1976 as we actually had with the combination of individual and corporation income taxes. Those rates apply to cash flow understood as an approximation of consumption.

I don't think there's any doubt that we could have a satisfactory degree of progressivity. The critical question is: When I choose to postpone consumption by a year, should that raise my tax burden? And it seems to me there's no fairness argument that says that it should.

Senator JEPSEN. Let me pursue this just a second with Mr. Kurtz. You say in your prepared statement that much of the complexity in our tax code results from progressivity, which you've been addressing.

Mr. KURTZ. Yes.

Senator JEPSEN. Other tax lawyers dispute this point. Professors Walter Blondheim and Calvin at the University of Chicago Law School, for example, have said it's remarkable how much of the day-to-day work of the tax lawyer in the income tax field derives from the simple fact that the tax is progressive. Perhaps the majority of problems are either caused or aggravated by this fact.

I wonder if you could comment on that.

Mr. KURTZ. Yes, I would comment on that. First, I don't agree with that. The day-to-day work that I do—and I'm a practicing tax lawyer

in Washington—is not the result of progressivity, although there are complications.

Let me say, when I talk about complexity in the tax system, maybe I'm talking about a different kind of complexity. From the point of view of the total taxes that are collected in this country and from the point of view of trying to administer a tax system, what we're concerned about is the 100 million taxpayers in this country.

Progressivity may profoundly affect the tax lives of 1 percent of those people. That is, those at the very top of the rate scale. It has very little effect on the 99 million other taxpayers there. So to say that the tax lawyer's work represents only or by-and-large that top 1 percent is complicated by progressivity is not inconsistent with saying that very little of the overall complexity in the tax system is due to progressivity.

We're saying that it may have a substantial effect on the complexities faced by the upper 1 percent of the income population is what I'm saying, but that is not a major contributing factor to the overall complexity of the tax system.

Senator JEPSEN. Mr. Christian.

Mr. CHRISTIAN. I hate to do it, Mr. Chairman, but I have to agree with Jerry Kurtz on the point that I don't believe the progressivity has anything to do with complexity in the tax law. What has caused the tax system to be complex is not the fact that the rates are progressive. It's the fact that the rates are very high and those very high rates have produced this whole series of special deductions, credits, exclusions, and so forth, that simply would not be there. There would not have been these several decades of pressure to create all those exemptions had the rates not been high. So I don't believe that progressivity has anything to do with it in terms of complexity.

Senator JEPSEN. Mr. Roberts.

Mr. ROBERTS. Well, it's obviously the high progressivity which gives you the complexity.

Senator JEPSEN. I think the time has come for a summary and I would at this time, without any particular reason for selecting the sequence of efforts at tax reform only to increase the complexity that would like to make in closing?

Mr. BRADFORD. I would conclude by reemphasizing something that again is in my prepared statement and has been somewhat neglected in our discussion today in the degree of agreement on the thought of broadening the base and lowering the rates.

I would reemphasize the critical importance of doing that in a way that is motivated by a consistent view of what the tax system is after. I think it's only in that way that we can avoid simply repetition of the sequence of effors at tax reform only to increase the complexity that we've seen over the last 20 years.

Senator JEPSEN. Thank you. Mr. Kurtz.

Mr. KURTZ. I would simply try to summarize in a sentence or two to reiterate what's been said several times, but I think it is what is really at the heart of the discussion; and that is the tax system is too complicated and it's not too complicated because it has progressive rates. It's too complicated because there are too many deductions and credits which are unnecessary to the measurement of income. They ought to be eliminated which would produce a much broader base and would permit the significant lowering of tax rates which I think we all favor.

There's another issue as to whether those rates should then be flat or progressive and what the size of any exemption might be. Those are not complicating factors. Those are questions of political philosophy.

Senator JEPSEN. Mr. Christian.

Mr. CHRISTIAN. I think that the focus in any tax revision ought to be on the fact that the purpose of the tax system should be to raise revenue. It should not be to serve as an instrument of commercial or social regulation or an instrument for redistributing wealth.

Senator JEPSEN. Mr. Roberts.

Mr. ROBERTS. Thank you, Mr. Chairman. I think that the effect of the tax system has to be seen in terms of its overall effect upon the economy, that when we look at the current tax system in that way it is an unsuccessful tax system, not just from any revenue raising considerations but from the fact that it makes the economy unsuccessful.

I think that when we look at distributional problems we cannot limit those to taxation for two reasons. One, we have to consider the expenditure side of the budget; and, two, we have to take into account the adverse effects on opportunities of people of a tax system which reduces economic success. And when we look at it in this broad way, then I think you have a very strong case for low and constant marginal rates of taxation which would be a flat rate system.

Senator JEPSEN. Thank you very much, gentlemen, for your testimony and the exchange of ideas and information. It's been very informative and it will be one of the best records that I think we've compiled in this area for a long time. Thank you very much.

The subcommittee is adjourned.

[Whereupon, at 12:30 p.m., the subcommittee adjourned, subject to the call of the Chair.]

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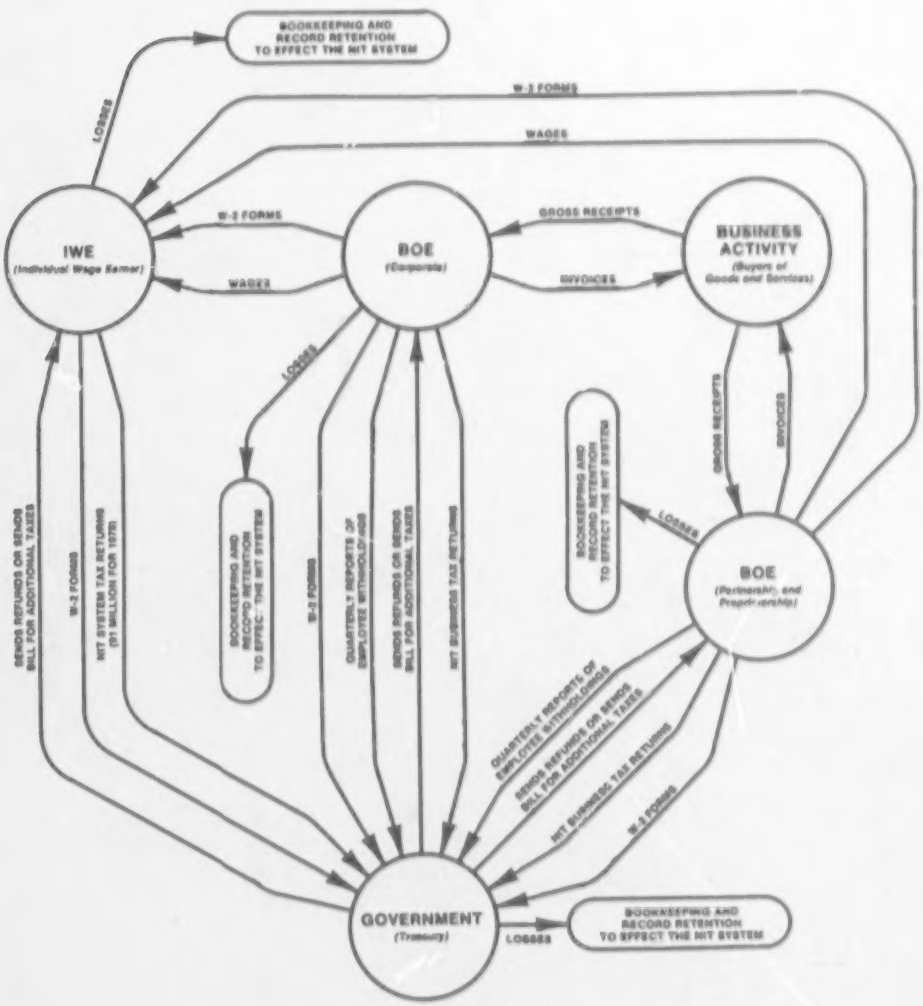
THE FLAT RATE TAX

Hearings before the Subcommittee on Monetary and Fiscal Policy of the Joint Economic Committee, Congress of the United States, Ninety-seventh Congress, second session, July 27 and August 19, 1982.

Please place figure A following page 205, which was inadvertently omitted from the hearings.



NIT SYSTEM

ADMINISTRATIVE WORK FLOW

Figure A

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